BANKERS AND CREDIT

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BY

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"THE MEANING OF MONEY," "THE CASE FOR CAPITALISM," ETC., ETC.

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PREFACE

WHAT happened to our monetary system during and after the war, some of the things that a crowd of critics and reformers want to do to it now, and the reasons which seem to me to confirm the opinion of our leading bankers, that the first thing to do is to get back to the gold standard on the pre-war basis, are the subject of this book. It cannot claim to have covered all the suggestions of all the monetary reformers, who have been multiplied almost as fast as money by the efforts of our politicians. All that it can hope to do is to cull a few of the brightest flowers of the criticism that has bloomed so freely, and to put before the lay reader, in language that he can understand, some of the ambitions of those who believe that the economic Paradise is to be won by monetary manipulation. Dryden thought that "no Government has ever been,

or ever can be, wherein timeservers and blockheads will not be uppermost" Without going all this way with him, we may safely contend that the financial achievements of our war Governments do not encourage us to increase official control of the Money Market

HARTLEY WITHERS

August 26, 1923

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OUR PRE-WAR MONETARY SYSTEM

On one of those pleasant after-dinner occasions when a Chancellor of the Exchequer is expected to unbend and to tell the nation and especially the City how well they are faring under his judicious treatment, Sir Robert Horne quoted Comte's belief that in a well-governed community all political power should be wielded by bankers. He added, however, that we can only arrive at this delectable situation when civilization attains the apex of its achievement, "and for this reason: I am sure we must all realize how hard it is to become a banker. I think I am right in saying that in all history, so far as we know, there is only one great statesman who has succeeded in becoming a banker, and I believe he presides over the London Joint City and Midland Bank." (Laughter and cheers).[1]

Whatever we may think of this doctrine that

[1] *Times*. July 21, 1922.

bankers are the best political rulers, there can be no doubt that political rulers have lately shown amazing capacity for creating chaos in the world of banking. Under the stress of war they seized and warped for their own purposes the banking and currency system of this country and of all other countries engaged in it and of many of those that were only affected indirectly, with the result that a system which had been brought to something very near to perfection is now

"Like sweet bells jangled out of tune and harsh,"

a melancholy mockery of its former beauty and efficiency. Makers of this chaos claim that it was a necessary part of the cost and consequences of war. If so, it is only one more joint in the harness of our so-called civilization, which had not even taught us how to conduct mutual slaughter on a world-wide scale, without very nearly wrecking the means by which we used to buy and sell. In some countries, indeed, the wrecking process may be said to have been complete. In August 1923 the German mark fell to about a two millionth of its pre-war value in sterling, being dealt in, or quoted, at 40 million to the pound.

In England the achievements of our rulers

in the matter of currency chaos were much less devastating in their effects. With us the highest point touched by the prices of commodities, which is the rough measure of the debasement of the buying power of our money, showed, as marked by the *Economist* Index Number, a multiplication in the course of nearly six years by a mere trifle of 3¼ as compared with the pre-war average, and in the course of the next two years this 3¼ was divided by two. Taking 100 as the figure for the general level of the prices of goods in July 1914, March 1920 recorded 325 and February 1922 showed that the average had come back to 166.

The effect of this rapid backward swing was in some ways much more disconcerting to industry than that of the previous rise, which had, while it lasted, greatly simplified the problems of production and commerce by ensuring a continuous advance in paper profits to all who held a stock of goods. But even the uncomfortable effects of this inconveniently rapid fall were preferable to the sapping of the foundations of the economic fabric that would have been involved by the continued progress of the process of debasement. Indeed, when we think of all that has happened to the

English Money Market during and since the war, it seems to have good reason to be surprised, and proud of itself, when it finds itself still in existence and more or less doing its ordinary work. The marvel is, after the terrific shock that crashed upon monetary and all other business, that we have any financial institutions still standing on their legs. This is still more so when we remember that we of the common herd saw only a small part of all that happened. Much of the action took place behind the scenes. Banking statements and balance sheets were always designed rather to veil discreetly the modesty of our monetary institutions than to let the full light of day fall upon the beauties of their figures and proportions. Since the war this has been more than ever so. Much of the information that used to be made public has been withheld, and, owing to the enormous complications and cross currents behind the figures that have been published, it has been impossible to draw more than uncertain and halting inferences concerning their meaning.

We do know, however, that the English Money Market was made an instrument of war, and as such was very roughly handled. It was by no means the same machine when

it tried to take up its usual work when the war was over. Its basis and character had been radically altered. The politicians and officials who had charge of their country's fortunes during the contest found ready to their hand an almost too perfect financial weapon. This weapon they took and worked and overworked and twisted all out of shape. They did so chiefly because they found, in the Money Market's almost unlimited power to create credit, the easiest and most popular way of getting money that was wanted for the war. Money that they took by taxation meant a wrench. Money that they wheedled out of our pockets in subscriptions to loans meant much drum beating and effort. Money that they manufactured with the help of banks, thanks to the ever expanding elasticity of the Money Market, was much more easily come by and seemed at first to touch nobody's pocket.

Small wonder that politicians gleefully seized a weapon which solved for them one of the worst of the war's problems, and used it with a freedom that was only checked by the need for preserving the financial decencies before the critical eyes of neutrals, from whom it might be necessary to borrow. With such effect did they use it that the Money Market,

as it was before the war, is now a matter of ancient history. We are trying to struggle back to something like it, through a chorus of obstructive and objurgating critics who would rather try new systems. One of the objects of this book is to remind readers who are not versed in such matters of the benefits that our old system wrought for us, to show how it was twisted out of shape, and to put before them some of the proposals of the critics and reformers.

Before the war then our monetary system was based on gold, and the pieces of paper—notes and cheques—by which most of our large transactions were paid for, were claims to so much gold which the holder could turn into gold if he wanted to do so.

Our "legal tender" money—that is, money in which creditors were obliged to accept payment—consisted of golden sovereigns and half sovereigns and Bank of England notes, which were practically gold certificates. Silver and bronze coins were legal tender up to forty shillings and one shilling respectively.

Though practically a gold certificate, the Bank of England note issue was not wholly backed by gold in the Bank vaults; part of it was what is called "fiduciary," that is,

"confidence money," being currency backed not by metal, but by British Government securities. The amount of the fiduciary notes, however, was fixed by the Bank Act of 1844, and for many years before the war had stood at £18,450,000. Above that point for every Bank note in existence there had to be so much gold coin or bullion in the Bank of England's vaults. It is true that under the terms of the Act, a certain amount of silver (one-fifth of the total bullion) was allowed as backing to the note issue. This right to base the Bank of England note on silver, however, had not been used since 1861, and so, except to the extent of £18,450,000, the Bank of England note was actually a gold certificate. Its holder could always be certain of being able to turn it into gold on presenting it at the Bank of England. And this free and immediate convertibility of the Bank of England note was recognized as one of the chief props of the English monetary system. Anyone who had a Bank of England note, or any number of them, could rely upon being able to turn them into English sovereigns of the recognized weight and fineness without question and without delay, and to send the sovereigns to any country in which he wanted to put them.

The Bank of England note, however, was seldom seen in the course of ordinary payments. It used, I believe, to change hands in considerable quantities on race-courses, but as a general rule monetary business in this country was done, when it was a matter of comparatively small sums, by payments in gold, or in the subsidiary currencies of silver or bronze; or when larger amounts were being settled, by means of cheques drawn upon banks. These cheques also, though not legal tender, were always convertible, if the holder wished, into gold. Anyone who held an uncrossed cheque on an English bank and wanted gold for it could either go to it and demand its payment, in which case he would probably be offered the option of receiving payment in gold or Bank of England notes, and so could take gold at once. But if the bank preferred to exercise its legal right of meeting the cheque with Bank of England notes, which we have seen to be legal tender, then our gold seeker could take the notes to the Bank of England and demand sovereigns in exchange for them. Or, he could go to his own bank—and this he would have to do if the cheque which he held had been "crossed," pay the cheque into his account and draw against it. His own bank

again would have the option of paying him in gold or in Bank of England notes, but in ordinary times would certainly be prepared to provide its own customer with gold. If for some special reason it stood on its right to pay in notes then the customer would have to go to the Bank of England for the gold that he wanted.

Thus before the war all our money was gold or claims to gold. Since cheques give their holders the right to take gold, the banks could not make themselves liable to meet cheques unless they had a proportion, such as experience had shown to be sufficient, of gold or of claims on the Bank of England's gold against the deposits of their customers. And so our money—in which terms I include coins, notes and cheques—could only be increased in quantity—except within the limits laid down by banking prudence—by bringing in more gold from abroad to be used either in circulation or in reserves against notes or deposits.

This foundation on which the English monetary system rested was taken from under it during and after the war. Its importance is not, at first sight, very evident. To the man in the street it might seem that all he need ask

from the money that he takes in payment for his services, and pays out in payment for the goods that he needs, is efficiency in providing him with what he wants. As long as a piece of paper will buy things for him, he is not much cheered by the thought that he can, if he wants to, turn it into gold, which he would never want to do, except in order to turn the gold then, or on some "rainy day," into something else that he wanted. All this is quite true and was very sensibly recognized by most of us in the early days of the war when we were asked to help to win the war by paying all our gold into our banks and using the new Treasury notes instead, so that the gold might be sent abroad to buy things wanted for the fighting men.

Nevertheless, the patriotism of the public was promptly punished for the readiness with which it virtually renounced its right to demand gold and so gave the Government the power to print as much paper as it liked. Then the man in the street found out that money has not only to be freely convertible into goods, but must also, to do its work soundly, remain fairly steady in value and must, if possible, be convertible into the same quantity of goods to-day, and a week hence, and a year hence,

and a hundred years hence. For the consequence of giving the Government a free hand with the printing press was that debauch of currency and credit creation which has already been referred to and will have to be more fully described later. It brought in its train a rise in prices that inflicted great injustice on all who were not able to increase their money incomes, and also upon those who had lent money at a fixed rate of interest or had made long contracts, such as are usual when houses are let, by which the user of an article paid a fixed sum each year for its enjoyment. All these unfortunates found that the money they received brought them in a continually diminishing amount of goods when they tried to buy with it—in other words that paper money did not long possess the same efficiency in providing its holders with what they wanted, as was formerly shown by gold. For the simple reason, that gold cannot be multiplied indefinitely, and paper can; and, Governments being what they are, there is always great danger that a people which adopts a paper currency and so gives its Government the power of printing money without limit, will find that the Government is printing too much and is thus lowering the value of all the money in

existence, including gold, and causing a rise in prices with the evil consequences above set forth

Such was the great advantage for purposes of use at home of a money based on a metal which the Government could not multiply at will Perhaps even greater was its benefit in the field of foreign commerce If stability of prices is a blessing when we buy and sell goods and services to one another, it is still more so when we buy and sell abroad, if only because the transactions of foreign trade take a longer time to carry through and so involve longer credits The merchant who is selling goods to China or Peru and may have to wait months before he gets his money, is not encouraged to do so if he finds that by the time he gets his money, it has so much less buying power than he expected when he shipped the goods, that he has made a loss on the bargain instead of reaping a pleasant profit

When once the stability of prices is undermined by too much money being printed this may happen even to English merchants who have stipulated for payment in English money But when payment is made in foreign money and foreign governments are working the printing press even more vigorously than ours,

then the problem becomes complicated by violent movements in "exchange," that is in the value of other moneys as expressed in pounds. Instability and uncertainty play a duet with a *crescendo* movement that ends in a crash of hideous discord. As everyone knows these things have happened on a scale which has reduced foreign trade to a blind gamble and made more evident than ever the blessings that were secured to us by the gold standard, as used by us and the other economically civilized countries.

For they also had currencies which were more or less convertible into gold. It was always the boast of England that only in England did we enjoy ready convertibility, that only here could any holder of a monetary claim rely with certainty on being able to convert it into gold on demand. Nevertheless, though in other centres convertibility may not have been as free and certain and quick as it was here, it was at least the ostensible basis of the monetary system, and when the system was squeezed steadily enough it had to part with gold. When, during the crisis of 1907, the Bank of England put its official rate up to 7 per cent. and so exerted really severe pressure on all the countries of the world to send their gold, which

they owed us or were prepared to lend to us, in order to help London to regulate and check the crisis which had been begun in America, the effect of this action was that gold poured into London from no less than seventeen other countries. Thus, though the gold basis of the currency systems of other countries was not as sure and solid as that of England, it was so to a sufficient point to secure that, at least in times of crisis and when sufficient pressure was applied, the principle of convertibility was allowed to work and the gold, when demanded, was surrendered to those who had claims for it and was allowed to leave the country and go to the place where it could be more usefully employed.

This gold backing to our monetary system and that of other countries in effect provided that all the great trading and financial countries were working with the same money. The nations coined the gold into coins of varying denominations and varying fineness, but the same metal was behind the monetary systems of all.

From this fact there came the great advantage that price levels were kept more or less in agreement in one country and another. If prices rose faster here than in other countries,

we became a good country to sell to and a bad one to buy from, goods poured in and our exports were checked, if this process went far enough then some of our gold had to be sent abroad to pay for the goods and services which we had been buying abroad beyond the value of those which we were selling. The result of this export of gold was that the basis of our monetary system was narrowed, and we had to put up for the time being with a smaller volume of money, because the loss of gold made it necessary for the banks to contract the volume of deposits and cheque money, so as to keep up their proportion between cash and liabilities. We had less money to spend and prices would tend to fall because there would be so much less money in our pockets and at our banks ready to pay for goods. We thus became for the time being a bad country to sell to and a good country to buy from, and the process by which we had been buying too much was reversed. In this way big movements in prices could only take place in all the gold using countries together, and so the level of prices was kept much more steady than it would have been if each country could perform fancy variations on it without any reference to the tune being played by the rest of the

orchestra. So the gold standard, by a beautiful system of checks and balances, maintained price levels in harmony among all the countries that used it and allowed it free play.

Another effect of the use by the chief countries of the same money was that it steadied rates of exchange, which are the prices of their currencies expressed in one another. When claims on England were so plentiful in New York that the price of sterling money in dollars fell below a certain point which was called "gold point," then these claims were in effect sent to London for collection in gold which was shipped to America. The cost of shipping and insuring the gold and the loss of interest involved by its journey were the influences which regulated the gold point. When claims on London were scarce and in demand, the same principle worked in the opposite direction, and so the rate of exchange between London and New York, or between any two countries with monetary systems effectively based on gold, could not, in theory, vary beyond certain limits. Owing to the varying effectiveness of the gold standards of the gold standard countries, fluctuations often exceeded the theoretical limits, but they were very definitely checked and restricted.

Such then were the chief blessings that the gold standard gave to us and to other countries that used it:—

1. Stability of prices at home.
2. Parallel movements in our prices and those of other gold using countries.
3. A limit on fluctuations in rates of exchange.

Stability of prices was by no means perfect; but the fluctuations that happened all through the century before the war were not much more than a ripple on the surface as compared with the tidal waves of the war and after-war period. It is only since we have lost these benefits owing to the surrender of a currency based on gold and the adoption of one based on the whims of politicians and the insolvency of Governments that we have fully recognized the beauties of the system that our rulers and those of other countries thought it necessary to wreck.

This system was provided for us partly by the Government, but chiefly by our banking machinery. The Government minted for us gold and subsidiary coins which we used in retail transactions and the Government had, by the Bank of England Charter Act of 1844, settled the terms under which the Bank of

England was allowed to issue notes. Since these forms of currency or money were, as has been stated, legal tender, and so by the law of the land had to be accepted in payment by any creditor who had a claim for money, it was clear that they had to be subject to legal restriction. But the Bank of England's ordinary banking business, apart from its strictly regulated note issue, was left entirely to the discretion of its Governor and Directors; and we shall find that they, by the growth of a convenient monetary convention, were able to give quite unregulated elasticity to the otherwise too tight-laced system devised by Parliament. And still further elasticity was provided by the fact that the cheques, which had come to be the form of currency in which nearly all the big commercial transactions of the country were settled, were drawn on the banks by their customers according to mutual arrangements which were subject to no legal regulation, but depended solely on the prudence and sagacity of the bankers in granting credits against which cheques could be drawn.

Thus in the three generations before the war the bankers had taken the manufacture of money, in the widest sense of the word, out of the hands of the Government into their own,

had broken the bands of the strait waistcoat in which business had been officially swaddled and had given it room to grow subject solely to regulation by banking prudence. Government had its revenge when the war came by making the bankers use the machine to suit its own purposes, expanding the elasticity with which they had endowed it into a Gargantuan balloon blown out to meet the exigencies of bad war finance.

The pre-war system can be most simply studied by looking at the balance sheet of one of our English banks, a summarized specimen of which is given below. Among the liabilities the large item of current and deposit accounts represents the extent to which the customers of the bank are able to call upon it to meet cheques drawn upon it. In the case of current accounts the money so held by the customer to his credit can be withdrawn at any moment. In the case of deposit accounts a certain amount of notice, usually a week, is required. But even in this case if the customer wanted money in a hurry he would certainly be able to arrange with his bank, though it might cost him something to do so, to be able to draw against his deposit account forthwith.

LONDON CITY AND MIDLAND BANK.

BALANCE SHEET—June 30, 1914.

Paid-up Capital	£4,348,650	Cash in hand and at Bank of England	£15,128,192
Reserve Fund	3,700,000	Money at Call and Short Notice	12,510,356
Current, Deposit and other Accounts (including Undivided Profits)	95,027,439	Investments	8,835,697
Acceptances	7,353,110	Bills of Exchange	10,230,300
		Advances, Loans and other Accounts	54,081,382
		Liability of Customers for Acceptances	7,353,110
		Premises	2,290,162
	£110,429,199		£110,429,199

Bankers had to decide in the light of their long experience of these matters, the proportion which prudence required them to maintain between this mass of deposits, which they might be asked to meet in cash, and their holding of cash, on the other side of the balance sheet. A rough and elastic proportion was thus established between their holdings of legal tender cash and credit at the Bank of England, and the extent to which the banks could create deposits by granting credits to the community. It will be seen, when we look again at the balance sheet, that, besides their cash, the banks held assets which, in varying degrees,

could be turned into cash. They held loans at call and short notice, which are probably loans granted to bill-brokers and stockbrokers in the City of London, which, in ordinary times, a bank is easily able to call in. They also held a large portfolio of bills discounted, that is to say, bills of exchange or Treasury Bills which are, in most cases, a promise to pay issued by other banks or leading London finance houses, or merchants of established reputation, or the British Treasury, falling due at various dates, and quite certain in the ordinary course of business to be met at the date of maturity. They also hold investments in British Government and other securities, which, in most cases, could only be turned into cash by being sold on the Stock Exchange at the best prices they would fetch. In the case of most of them there is a practical certainty of being able to sell rapidly, and at a price near or above the price at which they stand in the books of the banks which held them.

The largest item on the asset side of the balance sheet consists of the loans and advances to customers, through which the banks of this country perform their function of directly assisting British trade and production, by supplying credit to customers in order to finance the enter-

prises in which they are engaged. These advances are clearly less liquid than the rest of the assets held by the bank. Nominally, they are usually repayable at an early date. But a bank which had made an advance to a customer would naturally hesitate much more about pressing him to repay it, if doing so would hamper him in the course of his business, than it would about calling in loans from bill-brokers and stockbrokers, or other professional dealers in credit, or by selling its own investments in the Stock Exchange.

But the most important thing to be noted about the banks' balance sheets is that by making these advances and making these investments the banks create new credit, which becomes expressed in deposits, either in their own books or in those of other banks. Whenever a bank makes a loan, it gives the borrower the right to draw upon it to the extent of the amount of the loan. The borrower, who gets this right, exercises it by drawing a cheque, which he pays out in the course of the transactions for which he had arranged the credit. Whether it is a case of a bill-broker, who borrows to finance a purchase of bills of exchange; or a stockbroker, who borrows to carry securities for his clients who hope to sell

them at a profit; or a merchant, who borrows to buy commodities; or a manufacturer, who borrows to pay for raw material; or an ordinary individual, who borrows because he wants to buy an estate and has not yet provided, by the sale of securities or otherwise, the money that he needs for his purchase—whatever the reason for the purpose of the loan may be, the result will be the same. The borrower gets from his bank the right to draw the sum in question, say £20,000. He pays this £20,000 to the seller, to whom he owes money for bills of exchange or securities or raw material, or whatever it may be, and the seller pays the cheque into his own bank. The cheque goes through the clearing house and transfers £20,000 from the credit at the Bank of England of the paying bank to that of the receiving bank. The borrower's bank holds £20,000 less of cash at the Bank of England and £20,000 more in the shape of a loan to customers. The total of its balance sheet is unaltered and there has been a change, almost negligible in the vast total of its whole figures, in the nature of its assets. The seller's bank, on the other hand, has added £20,000 to its balance at the Bank of England and on the other side of its balance sheet the seller's account has been

increased by this £20,000 This addition to deposits has been directly caused by the credit created by the borrower's bank

The same result appears if a bank buys bills of exchange from a bill broker—it parts with so much cash at the Bank of England which the broker transfers to his bank, so increasing both its cash and its deposits Again, if a bank makes an investment by sending a broker into the Stock Exchange and buying, for example, £100,000 worth of Consols, it pays the seller £100,000 by a draft on its balance at the Bank of England Its holding of cash is thus reduced by £100,000, its holding of investments is increased by the same amount, but the seller of the Consols pays into his own bank £100,000 of new credit, which has been created by the purchasing bank The same thing happens when a bank, instead of buying securities on the Stock Exchange, invests by subscribing directly to a new issue made by the Government or any other borrower The only difference is that in this case it hands over a draft on its balance at the Bank of England to the issuer of the loan instead of to someone who is selling through the market As before, its cash is depleted, and its investments are increased by the amount of the transaction, but

the issuer of the loan has got a cheque which he pays into some bank or other increasing its cash and its deposits. If the final receiver of the money borrowed or invested is a customer of the lending bank, then the lending bank will have increased its own deposits; its cash at the Bank of England will be unchanged, and its advances (or investments) and deposits will both be increased by the sum of the loan.

It is thus of the utmost importance to remember, as will be seen when we go further into our subject, that whenever a bank makes an investment or a loan or discounts a bill it is increasing the deposits, either of itself or of some other bank—of itself if the person to whom its borrowing customer finally pays the money lent is also one of its customers; as in the case of an investment if the seller of the security is one of its customers, or hands on the money received to one of its customers. By this process the banks create buying power or what may be called potential currency. They create the right to draw cheques, which are usually received without question in payment for commercial and financial transactions. But the extent to which they can engage in this currency making business is roughly limited by

the extent of their holding of cash—legal tender money—and balance at the Bank of England; since they have to consider the proportion between their cash holding and their liability to their customers on current and deposit account. The amount of their cash holding depended, before the war, on the amount of gold that was in the country, since legal tender was then gold or a Bank of England note; and the amount of their balance at the Bank of England depended largely on the action of the Bank of England in creating credit by lending and investing, which it had been left free to do at its own discretion by the Bank Act of 1844, which had tied its hands so tight in the matter of note issue. And now we have to look at a pre-war specimen of the Weekly Return issued by the Bank of England:—

BANK OF ENGLAND.

Account for the Week Ended Wednesday, July 15th, 1914.

ISSUE DEPARTMENT.

Notes Issued	£56,908,235	Government Debt	£11,015,100
		Other Securities	7,434,900
		Gold Coin and Bullion	38,458,235
	£56,908 235		£56,908,235

BANKING DEPARTMENT.

Proprietors' Capital	£14,553,000	Government Securities	£11,005,126
Rest	3,431,484	Other Securities	33,623,288
Public Deposits	13,318,714	Notes	27,592,980
Other Deposits	42,485,605	Gold and Silver Coin	1,596,419
Seven Day and other Bills	29,010		
	£73,817,813		£73,817,813

It will be seen that the account is divided into two portions—the Issue Department and the Banking Department. As everyone knows, this eccentric and unique arrangement was imposed upon the Bank of England by Parliament, when it devised the Bank Charter Act of 1844. The Issue Department shows the total of the Bank of England notes issued with the assets held against them on the other side. These assets consist of gold coin and bullion to the extent of the whole amount of the note issue, except the £18,450,000, the fiduciary issue which is permitted, as already described, and was in February 1923 raised to £19,750,000. The Government debt is merely a book debt between the Government and the Bank of England—the very much expanded descendant of the £1,200,000 which was lent to the Government of William III., when the Bank of England was originally

founded There are also other securities in the Issue Department which are, and in fact always have been, securities of the British Government But it should be noted that nothing in the Bank Act restricted the Bank of England to securities of this kind for the backing of the fiduciary part of its note issue

When we look at the Banking Department's figures we find it much more similar to the balance sheet of an ordinary bank Capital of course explains itself "Rest" is the somewhat eccentric title under which the Bank of England describes its reserve fund, which is also eccentric in the fact that it fluctuates with a frequency and to an extent which is unusual with other reserve funds In fact this item appears to include both the reserve fund and the profit and loss account

In the next two items we find the real significance of the Bank of England's position The Public Deposits are the deposits of Government Departments, and it need not be said that the Bank of England's position as bank of the British Government, has been in the past the main cause of its great prestige and of its paramount position in the London Money Market Nowadays, perhaps, the next item is even more important The Other

Deposits include the balances of the chief English banks, all of which keep an account at the Bank of England, through which they settle the balances of the huge transactions between one another that are carried through every day by the clearing house, and this balance at the Bank of England is included by the other banks, with their holding of legal tender currency, as " cash" in their balance sheets and statements. It must be noted, however, that the Other Deposits include many accounts besides those of the banks included in the clearing house system, commonly called the clearing banks. They include the balance of the Indian Government, Colonial and Foreign Governments, home and foreign Municipalities, and the many private customers of the Bank of England; and since, as we have seen on looking at the balance sheet of one of the clearing banks, these institutions do not separate their cash at the Bank of England from their holding of legal tender cash, one of the chief clues to the real position of the Money Market, namely the amount of cash at the Bank of England held by other banks, is always veiled from the gaze of the curious.

On the other side of the account we are faced by similar obscurities. Government securities

include only promises to pay of the British Government, but they may be in the form of undated or long-dated loans, such as Consols or War Loans, or they may be Treasury Bills, or they may be temporary advances, which the Government secures from the Bank of England in the form of Deficiency Advances for meeting interest due on Government debt; or Ways and Means advances necessitated at a time when the revenue of the country is coming in too slowly to meet the daily payments that the Government has to make. The "Other securities" include every investment or promise to pay that the Bank of England may hold, other than those issued by the British Government. And advances that it may make to banks, though banks very rarely borrow from it, or to bill-brokers, stockbrokers, or its ordinary customers, are here jumbled together in a comprehensive medley, with the result again that inferences drawn from the movement upward or downward of this item are extraordinarily likely to mislead the too curious inquirer.

We saw that any investment or loan made by an ordinary bank increased the deposits in the hands of itself or of some other bank. When the Bank of England makes investments

or advances, it increases the deposits that it holds, either "Public" or "Other," either on account of the British Government or of some other customer. Since the Public deposits, the balances held by the public departments, are in normal times a more or less constant quantity, the usual effect of any advances that may be made by the Bank of England, either to the Government or to anybody else, is to increase the total of the "Other" deposits; since what the Government borrows it pays out to individuals or companies to whom it owes money and they pay it into their own banks.

It may happen occasionally that those who are given an advance by the Bank of England may use it in order to withdraw cash, just as a borrower, who borrows from an ordinary bank in order to pay wages to his workmen, may take out coin for that purpose. In either case, however, it is most likely that the coin or notes so taken out will come back in the ordinary course of trade to be deposited with one bank or other in the case of ordinary banks; or with the Bank of England itself in the case of advances made by the Bank of England; but in the latter case there is the exception that demands made upon it for cash may—or might in pre-war days—take the form ultimately of

demands upon the Issue Department for gold for purposes of export. When this happened, instead of an addition to its deposits being shown, a decrease in the cash holding of its banking department would follow and the proportion between its reserve and its liabilities declined. Its reserve consists of the last two items on the assets side, by far the larger one being composed of notes—its own notes issued by the Issue Department. Anybody who, by borrowing from the Bank of England, secures credit in its Banking Department can exercise that credit by taking out some of the notes held in that Department's assets. Before the war, he could then go to the Issue Department and take out gold in exchange for his notes, which were forthwith cancelled, because their gold backing had gone. The consequent reduction of the Bank of England's reserve, and of its proportion to liabilities would immediately be noted by the market as likely to cause the Bank, if the process went further than it thought prudent, to raise, by an advance in Bank Rate, the price at which it would grant credit. Bank Rate is the official minimum rate at which the bank will discount bills; and the rate at which it will make advances is usually ½ per cent. above.

Thus we see that the Bank of England, like the other banks, creates credit by any advances that it makes; and its action in so doing is of especial importance because the credit that it creates is regarded as cash by the other banks. If it lends money to Government to pay interest on Government debt, the Government draws upon the credit so created, and pays out cheques to the debt holders, which they pay into their banks, and so there is finally an increase in the balances of the Joint Stock banks at the Bank of England and in the amount of the Bank of England's "Other" deposits. On the other side of the account there will be an increase in the Bank of England's holdings of Government securities. The same thing happens if the Bank of England lends money to the Government to pay for a battleship, or to meet the salaries of its officials, or if it lends money to any other borrower for any other purpose. The borrower draws a cheque, which is paid into one bank or another and increases the credits held by the banking community at the Bank of England. And, as has been shown above, other banks include their credits with the Bank of England with their legal tender cash. Thus, whenever the Bank of England lends, it places at the

disposal of the other banks, a sum which entitles them to issue for the purposes of the general public, a much larger amount of credit. On the other hand when the Bank of England reduces its securities, either by selling stock or by inducing its borrowers to liquidate their loans by charging them a higher price for them, which it does by raising its official rate of discount, the effect is to contract the basis of credit and to cause a still greater contraction in credit, so that the proportion between cash and credits may be maintained more or less on the usual level.

Thus the system worked in the old days with an efficiency, which roused the envy of the rest of the world, though it was plentifully criticized by those whose withers were galled by its restrictions, which as we now see, had so beneficial an effect in steadying prices. Owing to the terms of the Bank Charter Act it was not possible to increase the volume of legal tender currency in the country, except by attracting gold from abroad in payment either for goods exported, or of debts called in, or of loans raised. Theorists could easily show that a currency system based on gold does not secure perfect stability of prices, because the quantity of gold produced often varies in relation to the

quantity of goods coming to market; and the Quantity Theory of money shows us that steadiness of prices is secured, or assisted, by steadiness in the relation between the volume of money and that of goods. Practical business men, who often want more credit than is good for them, used also to rail at the restriction upon the credit facilities of the country involved by the gold standard. They argued that industry can only expand if any adventurous person who thinks that he can make a profit by starting and organizing " enterprises of great pith and moment " can always be certain by applying to his bank to get as much credit as he wants, and that the limitation on the power of banks to create credit, imposed by the gold standard, made industry most absurdly depend on the amount of gold that was being dug up out of the bowels of the earth and shipped to this country.

Certainly it is easy to make merry over a system based on a metal which was chosen by mankind as a medium of exchange, because of its universal appeal to male and female vanity, and is even now, owing to the hoarding habits of primitive peoples into whose control it comes, often dug up in one quarter of the globe only to be buried in another. But imperfect

stability of prices secured by the gold standard has been seen to be much better than the perfect instability produced by the printing-press in the hands of impecunious Governments. And the monetary system of England had in effect very cunningly weakened the restrictions of the Bank Charter Act by establishing, as part of the foundation of our credit system, the principle that a balance at the Bank of England can be ranked as cash with gold or gold certificates. Balances at the Bank of England could be, and were, expanded at moments of exceptional demand to any extent that the Bank of England thought prudent. When demands arose for expansion of credit, and the ordinary banks found that their proportion of cash to liabilities was becoming too low, all that they had to do was to call in part of their loans, which they habitually advanced to the London bill-brokers as their second line of reserve. The bill-brokers, in order to repay these loans, went to the Bank of England to borrow, and it lent them money with which they paid off their loans to the other banks. So the balances at the Bank of England of the other banks were increased, and the cash basis of our credit system expanded with extraordinary ease by a

few entries in the Bank of England's books. This easy elasticity, which made our monetary system an almost perfect machine when worked by bankers for financing our production and trade, lent itself only too well to abuse by politicians, when a great war called for sacrifice, but the politicians found it simpler to invite us to make money out of our country's need.

CHAPTER II

THE WAR-TIME BULGE

WHEN war comes there are five ways in which a modern Government can provide itself with the sinews thereof:—

1. It can take money out of the citizens' pockets and bank balances by making them pay taxes.

2. It can get money from them by issuing loans which they subscribe for by saving.

3. It can borrow abroad.

4. It can get money from banks by issuing loans to them which they subscribe for by creating new credits; or it can get money by issuing loans to people who subscribe not by saving but by borrowing from banks which create new credit for this purpose.

5. It can print notes and issue them itself.

The ideal method is obviously number one. With it, the goods and services needed for the war are bought by the Government with money which the citizens, having paid it in taxes, are unable to spend on themselves. There is thus

no increase in the aggregate demand for goods and services and there need be no rise in the general price level. Goods wanted for the war go up in price, but articles of luxury and all those commodities and comforts in which people have to stint themselves in order to pay the increased taxes, tend to go down, as happened when the war began. If a war's needs could be wholly met in this way, it would leave the nation with no debt and no debasement of currency. Producers of luxuries would be hit, but only for a time and until they adapted their activities to war production, the demands of which are now so great that they quickly absorb all available energy.

Number two—financing war out of loans subscribed with saved money—also has the great advantage of transferring the buying power of those who save to the Government for buying goods needed for the war. This method also should cause no rise in the general level of prices, because the Government's increased demand for goods would be offset by the reduced demand of those who saved to subscribe. This was the kernel of the doctrine preached, with astonishing success, by the War Savings Committee during the war. The objection to the system is that it leaves a debt

behind, the interest and redemption of which have to be met from taxation. It thus postpones taxation and holds it over until after the war. This is not a good thing to do in the case of a people that is prepared to face war's burden at once, because taxation is more easily paid in war-time, when industry is fully occupied with turning out goods to meet an insatiable demand, than it is when peace comes and industry is faced with the difficult task of readjustment. The taxation needed for debt charge, when the debt is held at home, only distributes and does not lessen the nation's wealth; but it is not therefore any more pleasant to those who have to pay it. But from the point of view of politicians who want to make things look pretty, the borrowing system has the advantage that it gulls the nation with the belief that the war is not hurting its pocket very much. The Government hands out promises to pay in the shape of War Loans and the citizens are apt to forget that when the Government promises to pay it can only meet its promises out of their pockets.

This delusion would not do much harm, if all the nation were affected equally. If we preferred to leave the task of paying for the war to those who were patriotic enough to save,

and everybody had the same chance of saving, in relation to their wealth, then it would be fair enough that we should all be taxed in relation to our wealth to pay interest to those who had made the patriotic effort when it was called for. But things do not happen so. In war time, the best of us, in strength and courage and endurance and manliness, are risking death and wounds in scenes of indescribable dirt and discomfort and strain, and are doing this for very low pay compared with the salaries and wages earned by those who, not being fit to fight, are left at home. And so the opportunity for subscribing to War Loans is much less for those who, because of the work they are doing at the front, have more right than anybody else to be enriched by the war. When they come back to civil life they find that a war debt, to which they had little chance of subscribing, lays on them a burden of taxation at a time when they have more than enough difficulty in fitting themselves into industrial and professional work.

Number three—borrowing abroad—is a costly and difficult method, because a nation at war naturally has to pay a high rate on loans that it issues in foreign countries, the citizens of which take a detached view of its chance of

winning and of its probable solvency at the end of the struggle, and have no patriotic incentive to "feed the guns" that are not fighting their battle. It has the effect, very pleasant for the time being, of inducing the foreign subscribers to the loans to make the necessary sacrifice, in return for a rate of interest which has afterwards to be paid for out of taxation. But with this difference that the subsequent taxation, instead of being paid by the citizens of the borrowing nation and distributed among certain of their members, is paid to people in a foreign country and so is a much more effective drain on the national wealth. The interest and sinking fund, by which the loan is redeemed, can only be paid to the foreign creditors by the debtor nation's either selling abroad so much more of goods and services, or buying abroad so much less of goods and services. In either case its own enjoyment of goods and services is to that extent reduced.

Number four is easy and at first sight pleasant for everybody, but is, in fact, quite the worst way of raising money for war or any other purpose. When a Government borrows from banks it does not take money out of anybody's pocket or anybody's bank balance.

In fact it increases bank deposits which have already been described as potential currency because they give their holders the power to draw cheques or to take out cash from the banks. As was shown in the last chapter, whenever the banks *make loans they increase* the deposits of themselves and of other banks, and when the Bank of England makes loans it increases the balances of the other banks in its books, and so gives them more "cash at the *Bank of England" which is part of the* foundation on which they build their fabric of credit. In the same way when the Government borrows from investors, not money that they have saved, but money that they have borrowed from their banks, there is again an increase in potential currency. So that what happens is that instead of the Government's spending power for the war being provided by the reduction of other people's spending power, it is provided by a creation of new spending power. By this process nobody is taxed or bothered to save or make any other sacrifice, but in fact a sacrifice is imposed on the community, and is likely to fall on those least able to bear it. When it taxes a Government can regulate the sacrifice required according to the relative wealth of the taxpayers: when it

borrows saved money it gives the citizens the choice whether they will make the sacrifice; when it borrows from banks it creates fresh spending power, so lowering the value of all the money already in existence, including its own, and so perpetrating something very like a swindle, which robs those who are unable to increase their incomes and lines the pockets of those who have essential goods and services to sell.

To take a practical example let us suppose that the Government makes an issue of ten million pounds' worth of Treasury Bills which are taken up by the banks. The first result would be that ten millions would be transferred from the banks' balances in the Other Deposits at the Bank of England to the Government's balance in the Public Deposits, and the banks would have ten millions more Government securities or bills discounted, according to their system of book-keeping, and ten millions less cash at the Bank of England. But the Government would forthwith draw on its increased balance at the Bank, to pay for the fighting men's needs, and the contractors and others who received its cheques would pay them into their banks. Thus the ten millions would be transferred back from the Public

Deposits to the Other Deposits at the Bank of England, the banks would get back their cash at the Bank of England and would still hold their ten million Treasury Bills with an addition of ten millions to the deposits of their customers. This fresh ten millions will be an addition to the spending power of the community: the contractors who had received it would pay it out in wages to manual workers, in salaries to managers or in payment to merchants and producers for raw material. But at the same time there would be no corresponding increase in the goods to be bought, and so the outpouring of all this new money would merely mean fiercer competition for an unaltered mass of goods, on the part of the purchasers with new money in their pockets and purchasers with the previously existing money. And the only possible result is a rise in the prices of the goods, which is to say a fall in the buying power of the money.

The fifth method, by which the Government neither borrows nor taxes but just prints notes and pays its debts with them, produces the same evil results as number four, and more so, because it creates not only new credit but new cash which can be used as a basis for yet more credit; but it also has the great advantage of

saving the expense of the interest paid to banks. Our Government printed notes, though to a quite small extent as compared with the thumping figures of war finance, but instead of using them directly for payments, preferred to issue them in response to demands from banks, in exchange for so much credit at the Bank of England, most of which was then lent by the Currency Department, which handled the note issue, to the Exchequer which finally paid it out through the spending departments. By this elaborate machinery and a nicely constructed weekly statement showing a balance sheet with gold, cash at the bank and securities held against the notes, our conscientious officials managed to give an appearance almost approaching respectability to some 300 odd millions of Governmental "shin-plasters."

Thus the ingenuities and elasticities of the Money Market were prostituted for the production of the same result that was achieved by mediaeval monarchs who debased their currency by putting in too much alloy and so making their stock of metal go further. The modern ruler by multiplying banking credits and paper money plays the same confidence trick much more easily and extensively.

So began the dreary and disgusting race

between prices and wages, and between profiteers and Excess Profits tax-gatherers, which was to cause so much unrest and bitterness, which added so enormously to the cost of the war and the amount of debt that it left behind, which sowed the seeds of the after-war outburst with its feverish madness and of the subsequent collapse with its bankruptcies and disillusionments, which made it more profitable to squander than to save, which taught business men that economy in production was an irrelevant absurdity because the continuous rise in prices was certain to pour profits into their pockets if only they opened them wide enough, and taught the ignorant multitude to believe that producers, merchants and dealers were a set of ruthless extortioners who were wantonly flaying the skin off the nation in its need and off everybody else who had to buy goods. Mr. W. A. Orton in his very interesting work on *Labour in Transition*, in describing the workers' suspicions and apprehensions in the early years of the war, says that "by far the most potent factor of all was the question of the profits made by the armament firms; the suspicion—to quote an official report—'that while they (the workers) were called upon to be patriotic and refrain from using the strong

economic position they occupied, employers, merchants and traders were being allowed perfect freedom to exploit to the fullest the nation's needs.'"

Could this disastrous system have been avoided altogether? The official attitude assumes that it was inevitable, and perhaps to a certain extent it was, with the financial leadership that we enjoyed. Neither the Government nor the people understood what was happening. Our rulers were not making Machiavellian use of monetary dodges to delude the people and dilute the currency, but were taking the line of least resistance through a difficult problem, and incidentally making reckless use of a delicate machine which they did not understand and producing consequences which they neither foresaw nor recognized. The public thought the rise in prices was a necessary consequence of war and naturally did not attempt to connect it with the expansion of bank deposits. Indeed, when this feature was noticed it was often hailed, even by men of business who might have known better, as a proof that we were somehow growing richer in spite of the war. If we had had a Government which understood finance and had courage enough to tell the people that war

meant sacrifice, and if we, as a people, had had wit to understand, as we had, I believe, the courage and the will to face the sacrifice demanded, then the whole story of our war finance would have been very different.

A real statesman in charge of the war finance of an ideal people would have seen, and seen that the people saw, that, apart from what might be done by borrowing abroad, it could only win the war by its own efforts in producing more and consuming less, so that the goods needed to maintain and equip the fighters might be provided; that industrial effort on the one hand and abstinence in consumption on the other were essentials to success; that what was needed for the fighters must be taken from the citizens, and that the simplest, cheapest and fairest way of doing this was by taxation, so that for every pound spent on the fighters there should be a pound less in the pocket of a civilian. For the devious devices and dodges of borrowing and currency creation do not make the sacrifice a whit less. The fact still remains that whatever the fighters consume the civilians have to go without, always excepting what can be done by borrowing abroad and selling securities and other assets to foreigners. A Government and a

people that recognized these things at the beginning of a war and had sense and courage to apply them would pay for the war as it happened.

But neither here nor in any other country was there even a distant likeness to an ideal statesman in charge of war finance:

> with a puling infant's force
> They swayed about upon a rocking-horse,
> And thought it Pegasus.

In France and Germany no attempt was made in the early years of the war to meet any part of its cost by taxation. France with her richest provinces invaded had plenty of excuse. In Germany the docility, discipline and intense patriotism of the people gave a wonderful opportunity to its Government for financing the war soundly: but it was not taken because the Government preferred to finance by borrowing on the assumption that it was certain to win the war and recover its cost, and a great deal more, from its vanquished foes, rather than by "increasing the burdens of the people." Apparently it thought in its wisdom that it could lighten these burdens by bad finance. In fact the event inevitably showed that in Germany, in spite of the absence of taxation

for the war, what the fighter needed the people had to provide by stinting.

So it was that our Chancellors of the Exchequer had such examples set them both by friend and foe that whatever they did in the way of war taxation they were able to ascribe to an excess of virtue which made their war finance to that extent sounder than that of Germany or France. Judged by this standard of failure their achievement shone like "a good deed in a naughty world." Judged by what might have been, what ought to have been, and what was actually done in the course of the Napoleonic and Crimean wars, when nearly half the cost of the war was met by taxation[1] it was not a great performance. Mr. Lloyd George was our first War Chancellor and his most ardent admirers will probably admit that he is more successful in distributing the contents of the public purse than in calling on the general tax-paying public to stint themselves in order to fill it. It is difficult to exaggerate the evil effects of the economic crime that he committed when in the Spring of 1915 he imposed no taxation whatever to meet the deficit that faced him. Most eloquently he put the facts of the financial position before the

[1] *British Budgets*, by Sir Bernard Mallet, p 201.

country but made no attempt to apply even a moderate dose of the true remedy. And yet the bad eminence that he then reached as a War Chancellor defaulting in his evident duty was perhaps overtopped by Mr. Bonar Law in 1917 when he brought in a Budget which was expected to add £1,600,000,000 to the debt and added only £6,000,000 to permanent taxation. (He got £20,000,000 more from Excess Profits tax, which was then supposed to be an impost which would cease with the war.) Which of these two efforts was the worse, we may leave the two champions who achieved them to decide. Mr. Lloyd George did not tax at all. But he had an excuse (rather weak on its legs) in that he had taxed a good deal in the Budget that he brought in in the previous autumn, and a still feebler one in the belief, which most of us then cherished, that the war would be short. Mr. Bonar Law, whose contribution to taxation was so pitiful in comparison to his addition to debt, had neither of these excuses. On the contrary, between his rule and that of Mr. Lloyd George, Mr. McKenna had really tried to do all that he could to finance by taxation. The effort that he made was not too heroic, brilliant as it was when compared with those of our other War Chancellors. His Budget

speeches generally produced a sense of relief in the House of Commons and among the income tax paying class because he had not made a greater addition than he did to the income tax; and it may surely be argued that in war time it is not the business of a Chancellor to produce a sense of relief but to brace the taxpayers to an effort which might at least be a faint reflection of what the fighting men were doing for them at the front.

It may be that the taxpayer would have jibbed and kicked if Mr. McKenna, who at least set a sound standard of aiming each year at covering out of taxation the service of the anticipated addition to debt, had tried to do more. The view has been expressed by experienced taxgatherers that the great industrial effort which was certainly made by our people was only possible because the wage earners were stimulated by high wages and the organizers by big profits. But as everyone now knows industrial unrest was almost chronic in the later years of the war, partly because the wage earners believed that their high wages were fully offset by high prices and partly because they knew that their employers were making enormous profits, as shown by the passage quoted above.

Danger of an upheaval which would have reduced output and led to defeat, was a sinister possibility, but surely it would not have been increased but lessened if the war had been paid for, as it might have been, out of the current income of the nation, and out of the sale or pledge of existing assets abroad. To suppose that there are funds which can be tapped by borrowing but are sealed to the tax-gatherer is a slur on the efficiency of the latter which our Inland Revenue Office does not deserve. You cannot get more out of a nation than it can produce in goods and services, and if you deal bravely and intelligently with a brave and intelligent nation you get from it, for a great national purpose, all that it produces except what it must have to keep it alive. We could have met the whole cost of the war, which would not have been nearly so great if it had been better financed, without calling on ourselves to stint to that point. When we remember what the spirit of the country was like in the early days of the war, it is clear that if the right attempt had then been made to put the facts of war finance before the people they would have understood and accepted them and been prepared to face them, instead of being deluded by monetary will-o'-the-wisps, which

were quite useless for lessening sacrifice, but only too effective in distributing it unjustly and enabling a small minority to make fortunes out of the war that was bringing ruin to many, especially of those who were fighting for us.

These results were so far from being expected when the war began that the arrangement made by the Government with the railway companies, under which they were to be *guaranteed* their pre-war net revenue, was viewed with envy by the shipowning, coal-owning and engineering firms and companies which afterwards wallowed up to their chins in the war profits in which bad war finance immersed them, but then saw nothing but bad times ahead. The capitalist class was fearful and tame and quite ready to be told, what it already believed, that war meant sacrifice and stinting, and probably ready to be convinced that taxation was the cheapest and fairest way of imposing and distributing the burden. I remember being told by a stockbroker in the first week of the war that of course the whole Stock Exchange saw nothing but ruin ahead of it. "But we don't care a damn," he added. "We know this war had to happen and we know we're going to win and that's all that matters."

At the same time the spirit of the manual workers was an example to the rest of us. Mr. Orton tells us that, "despite widespread unemployment and distress among the rank-and-file of labour and the many practical difficulties with which its leaders had as best they could to contend, not these things but the universal tide of active patriotism will remain the dominant impression of this momentous autumn. Volunteers from all trades and classes were enlisting at the rate of nearly 100,000 a week: 174,901 during the first week of September; so that many a regiment would make a favour of it to put your name on a long waiting list, and many a depot had to close its doors on a press of volunteers much as in peace time the dock gates used to close on a press of willing labourers. Outstanding industrial disputes were broken off, compromised, referred to arbitration or waived altogether. Already in the first fortnight of August, employers and trade unionists on Clyde and Tyne had mutually agreed to assist in every possible way the execution of all work essential to the war —in the latter area, had even recommended the removal of "all working restrictions." Other unions were taking up a similar attitude; and the Labour Conference of August 25, before

it approached the Government for assistance for the union funds, had embodied the general opinion in a resolution, "that an immediate effort be made to terminate all existing disputes, whether strikes or lock-outs, and whenever new points of difficulty arise during the war-period, a serious attempt should be made by all concerned to reach an amicable settlement before resorting to a strike or lock-out." From 72,000 men involved in various disputes in mid-July the number fell to "practically nil" by the following February: for 99 new disputes originating in July there were only 14 in August. *This was the industrial truce, loyally* observed in spite of grave provocation during the first winter.

"And lest it be thought that this was a small matter, an obvious and unimportant concession, let it be recalled that the three years preceding the war were years of intense industrial struggle in which for the unions principles as well as pence were at stake; and that, even as regards wages alone, the truce involved spontaneous surrender of the essential factor in their bargaining power, in sheer reliance on the goodwill of employers and the State. Whatever amelioration of the average working-class standard of living the next few years might

have brought was thus staked on the hazard; and it was a stake that the war-bonus principle of subsequent wage advances did not in fact redeem."

Such was the spirit of all classes in the first six months of the war. Such was the chance that Mr. Lloyd George missed in his 1915 Budget. Instead of a financial statesman we had an adroit politician who, seeing the people through the eyes of political agents and party wirepullers, thought it advisable not to ask them to pay any more taxes at present. Then, as so often throughout the war, the Government completely misunderstood the readiness of the people to bear the war's burdens and so undermined and impaired that readiness. Bad war finance, then introduced, and the consequent rise in prices brought with them competition among employers to make as much as possible out of the country's need and so invited the workers to join the game of grab; and so came suspicion and envy and bitterness, smouldering industrial unrest which seriously hampered the nation's productive effort, spendthrift extravagance, public and private, which wasted its resources and antagonism between classes of which the end is not yet.

During the war period, August 1 to

November 16, the total spent by the Government, according to the *Economist's* weekly summary of war-time finance, published in its issue of November 23, 1918, was £8,656,000,000 and the amount that it raised by revenue was £2,220,000,000. Even if we could assume that the whole of the expenditure was for the war, and that the whole of the revenue was provided by war taxation, the latter is little better than 25 per cent. of the former, a sorry percentage compared with the 47 per cent. shown, according to Sir Bernard Mallet's calculation, in the Napoleonic and Crimean wars. But we are bound, of course, to deduct from each side the peace expenditure and revenue. If we assume this at £850,000,000 for the $4\frac{1}{4}$ years—a low estimate but therefore understating our case—the war expenditure becomes £7,806,000,000 and the war revenue £1,370,000,000, a percentage of just over $17\frac{1}{2}$.

It need not be said that this is nothing like an exact calculation; war revenue and war expenditure went on long after the war period and it will probably never be possible to get two economists to agree as to the sum that was spent by our Government on the war. But at least it can be claimed that the financial effort

made by our rulers through taxation was very much below the results achieved by their predecessors at times when the country was much poorer and much less united in its determination. And yet we know that these earlier and better precedents were in their minds. For in the speech which opened Mr. Lloyd George's Budget that imposed not one halfpennyworth of taxation he went out of his way, after calling the country's attention to the huge gulf between revenue and expenditure, to say that he could have filled it by taking less of the country's income than was taken at the end of the Napoleonic war. Thus he was of those that rebel against the light; for one can surely contend without being charged with idealistic rainbow-chasing, that what we did at the beginning of the nineteenth century we could have done again at the beginning of the twentieth.

It is not possible to guess how much of the money that the Government got by borrowing was real saved money contributed by investors and how much was new spending created by banks either through direct advances to Government or through loans to customers for the purpose of lending. Banking figures, ever discreet in their reticences, naturally drew no

distinction between advances made to customers for purposes of production and those made to furnish them with funds to lend to Government. The figures of the Bank of England's return were more than usually obscure during the war period owing to a system then adopted by which any surplus balances that the other banks held were taken from them by the Bank of England and lent to the Government in the form of Ways and Means advances. According to strict bookkeeping these operations should have been shown in the weekly return and would have greatly increased the Bank of England's liabilities and assets. But in fact this was not done and so the Bank return was more than ever a cryptogram rather than a guide, and those who patiently week by week worked out the proportion of its cash Reserve and its liabilities were at once the victims and publishers of a deception which was, if it effected anything towards maintaining our financial prestige abroad, justified by the seriousness of the struggle and the importance of financial prestige to its winning.

A more important effect of anxiety to maintain our financial prestige abroad was the necessity that it was believed to impose on

those who guided our monetary policy to keep up the price of money in Lombard Street, when its cheapness would have enabled the Government to borrow at much lower rates and so would have left a much less onerous debt charge The natural effect of the big creations of new credit involved by the war was to make money cheap and in the early months of 1915 the market rate of discount was below 1½ per cent Since as the war went on the Government was practically the only borrower, exports of capital being forbidden and new issues at home being only permitted with the sanction of a most exacting Committee, it is clear that if the Government had chosen to adopt this policy it could have helped itself to all the available capital at any price that it chose to offer, especially if it had at the same time administered to capitalists the very broad hint of compulsion if they did not subscribe, to which they were treated by Mr Bonar Law—as good a borrower as he was a bad taxer—when he was appealing to them to support his great and successful War Loan of 1917 But our rulers feared that if money was too cheap in Lombard Street, foreigners would withdraw their balances from London and so turn the exchanges against us by offers of sterling in foreign centres.

though in fact the New York exchange, and others, to a less extent, were kept "pegged" by borrowing for that purpose. And so money was made artificially dear by the rates at which Treasury Bills were offered and also by the measure already referred to by which the banks' surplus balances were borrowed by the Bank of England for the Government. And it was only in the last year of the war that a special rate was allowed on foreign balances and the market rate for home money was allowed to slacken slightly.

Another influence that made our war borrowing dearer than it need have been was a curious delusion long cherished by our financial rulers which made them think that in war time each loan issued by the Government must necessarily be offered with a higher rate of interest attached. In spite of the fact that the German Government was borrowing steadily with 5 per cent. loans issued in the neighbourhood of 98, our wiseacres insisted on an ever rising rate which culminated in the Autumn of 1916 when some 6 per cent. Exchequer bonds scored the high-water mark of this absurdity, and gave a quite unnecessary handle to well-meaning enthusiasts who were arguing that the capitalists were "doing their bit" by battening

on the nation's life blood. In fact the capitalists were quite good and tame, as was shown in the following January when Mr. Bonar Law renounced this expensive delusion in a speech at the Guildhall, calling for support for his great 5 per cent. loan offered at 95, and so yielding $5\frac{1}{4}$ per cent.; he said that "the terms offered were as good as the Government was justified in giving; that as long as there was money in the country the conduct of the war would not be hindered for lack of it; that if the loan failed, which it would not, the resources of civilization would not be exhausted; and that if other measures were taken, the rate would certainly not be $5\frac{1}{4}$ per cent. The enthusiasm with which this frank threat of financial compulsion was received by the Guildhall audience was remarkable evidence of the readiness of the City to suffer all things for victory." (*Economist*, January 13, 1917).

On this occasion the banks were not bullied into subscribing to the loan themselves but, as was done whenever a loan was offered, everybody was urged to borrow from his bank in order to apply. Clearly this had to be done in order to secure the great success of the loan, which brought in over £1,000,000,000 in cash. But unless the advances were repaid as fast

as the Government spent the money—which certainly did not happen—the result of this system was another addition to the volume of credit, expressed in increased bank deposits or potential spending power. The effects of the use made of our banking machine for war finance on banking figures may be studied by the curious in statistical compilations.[1] Here it may be noted that the total deposits of the Bank of England which stood at £71,000,000 at the end of 1913, were £155,000,000 at the end of 1914, and £241,000,000 at the end of 1918; the figures of the total securities at the same dates being £65,000,000, £145,000,000 and £231,000,000. The other banks of the United Kingdom showed the following movements:—

In Millions.	End 1913.	End 1918.	Increase.
Deposits	1,033	1,988	955
Cash and Money at call	294	612	318
Investments	191	520	329
Discounts and Advances	683	1,025	342

Thus was the bladder of credit blown out till it was, like Falstaff and his lies, "gross as a mountain," and might have seemed to be at bursting point had it not shown powers of still greater expansion in the after-war period, which

[1] Such as the very full and interesting *British Finance 1914-21*, edited by A. W. Kirkaldy. Published by Sir Isaac Pitman.

clapped another £500,000,000 on to both sides of the balance sheet.

It may safely be assumed that most of the increase in investments was due to subscriptions by the banks to various forms of Government securities issued for war purposes and likewise a large part of the increase in discounts and advances, because many of them included their holdings of Treasury Bills under discounts. Treasury Bills grew from £21,000,000 at the end of 1913 to £1,095,000,000 at the end of 1918, and though many of the new bills were placed with shipowners, munition makers and others who wanted a liquid form of investment for the huge profits that they were earning, the banks also took a big share of them. Owing to these huge profits that the industrialists were earning they had little need to rely on their banks for credit, so that the increase in discounts and advances was probably due, apart from Treasury Bills, to loans to customers for taking up war loans.

Both these processes by which the banks were used to finance the war—direct investment, and loans to customers for investment, in war loans—were bad for the country and for the banks. For the country because they meant the production of fresh spending power instead of spending power being taken

out of somebody's pocket, and for the banks because, except when the securities that they took were Treasury Bills or other investments with an early date of maturity, they were "locked up." When they subscribed to War Loans, as they were urged if not practically forced to do in the case of the earlier issues, they took over assets that they would not for patriotic reasons be able to dispose of as readily as they would wish, when the time came for them to return, after the war, to their real business of financing the requirements of trade. By lending to their customers to enable them to subscribe, they also got a more or less frozen security, because investors who had been stimulated to borrow from their banks in order to subscribe to War Loans could not well be pressed very hard to pay the loans off. If they were obliged to do so and had to throw stocks they had purchased upon the market in order to redeem the loans, the effect upon the market for Government securities and therefore upon bank balance sheets would not have been comfortable.

The question of the increase in the banks' holding of cash and money at call and short notice brings us to the currency expansion which was required to support this jerry-built addition to the fabric of credit. As was shown

in Chapter I, the banks for their own safety maintained a certain proportion between their liabilities in the form of deposits and their holding of legal tender cash, plus "cash" at the Bank of England, which meant a credit in its books. Before the war legal tender cash could only be increased (apart from the inward and outward flow of the home circulation) by additions to the country's stock of gold. Cash at the Bank of England could be increased as fast as it chose to make loans and discount bills and this gave our system the necessary elasticity. The great expansion has already been shown (page 65) in the Bank of England's holding of securities and also in its deposits, by which its power to create credit was used for war purposes, and it was also shown that the figures did not do full justice to its achievement. The expansion in legal tender currency was as follows:—

CURRENCY MOVEMENTS, 1913–1918.

	Dec. 1913.	Dec. 1918.	Increase or Decrease
Bank of England Circulation	29·6	70·3	+40·7
Scottish Banks Circulation .	7·7	25·1	+17·4
Irish Banks Circulation .	8·0	30·8	+22·8
Gold Coin in Banks and in Circulation[1] . . .	123	40	—83
Currency Notes . . .	—	323	+323
	168·3	489·2	320·9

[1] As estimated by the First Report of the Cunliffe Committee on Currency, etc.

These figures show that whereas bank deposits were roughly doubled during the war period, cash currency was multiplied by very nearly three, its relatively greater increase being probably due to the shifting of income into the hands of manual workers and others who did not keep accounts at banks. It will be noted that an entirely new form of currency was introduced. This is the Currency note, or Treasury note, which was invented in the first week of the war, in order to meet the banking crisis which began, and reached its worst point before we were actually at war. We do not yet know why it happened that in England alone the currency expansion which was thought to be necessary owing to war took this special form. In France and Germany the increase in legal tender currency was carried out through the official banks. They made advances to the Governments and the Governments took the advances in the notes of the Reichsbank or the Bank of France and paid them out to meet the demands of war. It has never been explained why the same thing did not happen in England. We do know that a committee of bankers long before the war had told the Treasury that in case of a banking crisis in this country we should need some

form of legal tender paper currency of smaller denomination than the Bank of England note which, as everybody knows, was not uttered in amounts below five pounds. We also know that this recommendation slept peacefully in a Treasury pigeon-hole; and though we were fully prepared on the naval and military side to carry out all that we had promised, and all the details of shipping the expeditionary force to France had been thought out with the closest care by committees of railway and shipping men appointed by Lord Haldane, the financial side of the matter did not appear to have been got ready with the same foresight.

Gossip says that the necessary committee which was to deal with this matter was just about to get to work upon it when the war broke out, but this story seems too good to be true. In any case when the threat of war happened certain excitable folk wanted more currency—some because they were stupid enough to think it would be safer in their own custody than in that of their bankers, others because they expected a rapid rise in prices and wanted a store of money ready to lay in a stock of food. Consequently the banks were asked to hand out cash to an extent that they found inconvenient and fell back on their

undoubted right to pay the customers who made these demands in Bank of England notes; and because Bank of England notes were not in smaller denominations than five pounds the public went to the Bank of England to turn notes into sovereigns. As everybody remembers, this crisis was met by a four days' Bank holiday and a banking moratorium and by the issue of Treasury notes of one pound and ten shillings.[1]

It might have been thought that the more obvious course would have been to permit the Bank of England (if it had not the power, which is uncertain,) to issue notes of one pound and ten shillings and to have suspended for the course of the war the restriction upon the note issue imposed by the Bank Charter Act. This suspension was in fact made under the Currency Notes Act of 1914. But perhaps it was just as well that this course was not taken; as it was the Bank of England only availed itself of the suspension of the limit on its note issue during a few days (as was stated by Mr. Asquith in Parliament in November 1915) and in none of its published weekly returns is it apparent. In all of the Bank Returns issued

[1] The more technical details of this crisis are described in my book on "War and Lombard Street." H.W.

during the war you find the £18,450,000 of Bank of England fiduciary issue maintaining its dignified immobility, while, at the same time the country was gradually being bespattered with a mass of paper money issued not by the Bank of England but by the Government. From the point of view of the Bank of England's prestige and even of the English Money Market as a whole it is possible that this fact may have been to some extent useful. Mankind wears such queer blinkers in looking at monetary matters that it is quite possible that some day the London Money Market may be able to point with pride to the fact that although paper money was poured out with a wanton hand during war it was a liability of the Government, and the Bank of England and the Money Market really had nothing to do with it. In fact this legend is already extant. So well informed an authority as Mr. Benjamin Strong, Governor of the Federal Reserve Bank of New York, told a Commission of the American Congress in August 1921, that "the Bank Act was not suspended in England" at the beginning of the war.[1]

[1] Report of the Hearing before the Joint Commission of Agricultural Inquiry. Part 13, p 533 Washington Government Printing Office.

The new notes were originally designed to be issued in the form of loans to bankers, who were empowered to borrow up to 20 per cent. of their liability on deposits in the form of Treasury notes, giving a floating charge upon their assets and paying 5 per cent. for the accommodation. (See the Currency and Bank Notes Act 1914, and explanatory Treasury Memorandum.) Naturally borrowing currency on these terms was not a process which the great English banks wished to carry on longer or to a greater extent than was necessary, and some of them never made use of it at all. From the beginning some of them did not borrow Treasury notes but paid for them with a draft upon their balances at the Bank of England, and in a very short time those which had borrowed paid the loans off from the same source, and simply held Treasury notes in place of so much credit at the Bank of England.

Thus the amount of Treasury notes that could be issued was without limit, seeing that the Bank of England's power to create credits in its books, described in our first chapter, was still more unlimited than it had been before. As was there shown the Bank of England's power to create credit was not

in any way restricted by law and was only controlled by the effect that it had, directly and indirectly, on the proportion between its Reserve and liabilities and on foreign rates of exchange, and consequently upon foreign demands for gold. During the war these controls no longer had any but a sentimental effect. It is true that the gold standard was in law maintained; the Treasury note was convertible into gold on demand at the Bank of England, the convertibility of the Bank of England note into gold had not been in any way modified by the Currency and Bank Notes Act of 1914, and the right to export gold was not, in law, taken away. Ostensibly and on paper, anybody who had a claim on England could still turn that claim into gold and take the gold away without question. And these facts were of some use for propaganda purposes when put before neutral countries as an example of England's overwhelming financial strength, in that she had been able to maintain convertibility and her gold standard, as compared with the action of Germany, which immediately on the outbreak of war relieved the Reichsbank of the duty of meeting its notes in gold.

In fact this was all "eyewash"; the British public was appealed to on patriotic grounds not

only not to ask for gold, but to pay all of its gold into the banks, and did so to a great extent. Anybody who had gone to the Bank of England with a £1,000,000 worth of Treasury notes or Bank of England notes would have found very great difficulty indeed in turning them into sovereigns and would probably never have succeeded in doing so. If he had, he would have had still more difficulty in sending the gold abroad. In the first place he would have known that even to attempt to do so would have marked him as a suspected person. In the second, the cost of doing so was so great, thanks to the activities of Admiral Tirpitz and his submarines, which made the risk very expensive to insure, that it would not have been worth his while at the rates of exchange which were current during the war and were officially maintained by borrowing operations carried out for that purpose. Though convertibility and the gold standard were thus ostensibly and officially maintained they did not count as part of the practical problem. There was thus no reason why the Bank of England should not multiply the figures in its books to any extent that was required of it, by increasing its holding of securities on one side of its Banking Depart-

ment's balance sheet and its Public and Other Deposits on the other; and the convention by which Bank of England money had come to be regarded as just as good as cash, presented to the British Government a simple and easy method of financing the war. The Government borrowed from the Bank of England on Ways and Means advances and also by selling to it Treasury Bills, War Loans and other forms of securities created during the war. In so far as the Bank of England took these Government obligations it gave the Government a credit in its books which the Government passed on to shipowners, contractors and others to whom it owed money, and it was thus added to the amount of other deposits included in the balances of other banks. By this method not only did the Government get a certain amount of money in hand to meet current payments, but also, by increasing the volume of cash at the Bank of England which the other banks used as part of the basis of their operations it enabled the other banks to carry huge increases in their deposits without diminishing their proportion between cash and liabilities.

Other banks used this increased credit at the Bank of England either by leaving it there in their balance or by taking it out in the form

of currency notes or Bank notes. Obviously, there are limits to which the ordinary joint stock banks can regard a credit with the Bank of England as just as good as cash. It is only so because they can rely, if sudden demands for cash come upon them, on turning this cash at the Bank of England into legal tender currency with which they can meet these demands. But this is a process which takes time and it is necessary for the other banks to be able to meet demands upon them on the spot. Consequently, it is true that the great expansion in bank deposits could not have been carried out if the increase in legal tender currency, provided through the issue of over £300,000,000 of currency notes, had not been available. To this extent it is true that the expansion of credit could not have been carried out without the expansion of currency and to this extent those people are right who maintain that the increase in currency, provided by the Treasury note issue, was the real cause of the credit expansion, which together with the currency increase had such a stimulating effect upon prices and consequently upon the cost of the war. But it is surely idle to spend time in arguing whether the credit increase or the currency increase was the real cause of the rise in prices.

They were both causes, and, as the system was worked, neither could have happened without the other.

Such was the effect of the war on the London Money Market. The gold standard was a fiction and it worked on a basis of cash provided by the Government's borrowing from the Bank of England and the printing of Government paper currency. The evil effects upon the community were a great addition, through the consequent rise in prices, to the cost of the war, the violent redistribution of income that follows from the same cause, and the suspicion, suffering and misunderstanding that thence arose. On the other hand it was in favour of producers and of all who use borrowed money and may have helped to stimulate their efforts for war production.

This fact that rising prices are in favour of producers is, within very strict limits, unquestionably an argument on the side of currency expansion and a reason why most producers who think about currency matters are in favour of it. To make the matter clear let us consider what would happen if the volume of currency of all kinds were doubled over-night and the consequent doubled competition for an unchanged volume of goods doubled prices all

round. Anybody who had borrowed a thousand pounds the day before this alteration happened would be very greatly benefited. If he were a bootmaker or a merchant or a retail dealer in boots he would find that, his stock of boots having doubled in price, he would only have to hand over half the amount which he would otherwise have calculated upon in order to satisfy his debt. The creditor, on the other hand, would inevitably to the same extent be at a disadvantage, because he would be paid back in money that had lost half its value. Thus currency depreciation is an advantage to debtors and is bad for creditors, while currency appreciation—or a fall in prices—has the contrary effect of putting a bonus into the pockets of creditors who are paid back, or receive interest, in money that has greater buying power than the money that they lent. As a general rule debtors are those who are engaged in active enterprise, production and distribution, industry and commerce. It is part of their business to work on borrowed money, while the creditor class are people who have saved money and rely on its interest to secure the support of themselves and their dependents in their old age, or the representatives of others who have carried out this saving principle in

the past and have handed on the proceeds to their heirs.

At first sight the economic advantage of the community lies in making things comfortable for producers and distributors, in other words, for debtors, and if we cannot achieve perfect stability a moderate amount of currency depreciation has something to be said for it, as long as we can be certain of putting on the brake at the right time and as long as we do not inflict too much hardship upon the creditor class and frighten them out of existence. For though the economic service which they render to the community is less obvious than that of the producers and distributors—so much so that many of the rather hasty "reformers" of our economic system blandly dub the capitalist a thief—the fact remains that without the accumulation of capital economic progress is impossible; and it will not be wise to frighten the private capitalist out of existence until we are quite sure that we have secured a substitute that will do the work equally well of providing capital for the further expansion of industry.

Moreover, as will be seen later, the process of currency depreciation, once started, is very difficult to check, and if it is reversed with a jerk is likely to produce even worse disasters

than when it was proceeding. If it cannot be checked it leads finally to economic chaos, as exemplified by a story, lately told by Mr. Lloyd George to a Lancashire deputation, of two men in Vienna, each of whom had 10,000 Kronen (Austrian crowns) "One paid 10,000 Kronen into the bank; the other put his into wine. He drank all the wine, but the empty bottles are now worth more than the 10,000 Kronen put into the bank." (*Times*, July 7, 1922.) Or is this another argument in favour of currency depreciation? Falstaff, that "globe of sinful continents" would swear very heartily that it is.

CHAPTER III

THE HOLDEN IDEAL AND THE CUNLIFFE REPORT

IN the meantime the disorganization of our monetary system had given a new chance to those who had, in days before the war, charged it with lack of elasticity and thought it should now be rebuilt on a new plan. These schemes of reform ranged, as will be shown, from a remodelling of our system according to the pattern devised in Germany and copied in America, to proposals which were based on visions too vague and shadowy to be grasped by an ordinary mind. To such a mind it would naturally seem that the machinery of business had already been turned upside down quite far enough and that there was no need to make confusion worse confounded by monetary changes the results of which might be surprising to their authors; but it must be remembered that towards the end of the war there was still a very general hope that peace would bring with it a new world, which would be more comfortably arranged for all its members than the one

in which we had struggled for an existence in the old Victorian times.

These dreams and aspirations were not altogether as foolish as they seem to be now, when a return to pre-war prosperity looks like a far distant goal, which we can only win with a great effort. We have to remember that the war had astonished us all by showing us how great had been the increase in man's power of production, and in his control over the forces of nature. In this country we had shown that we were able to do far more than everything which we had contracted to do before the war happened, namely, to maintain the mastery of the Allies at sea, to finance our poorer comrades in arms, and to supply an expeditionary force to act on the flank of the French Army. Not only had we done all these things, but we had also created and put into the field an army on a Continental scale; we had provided it with equipment and munitions to an extent that had never been dreamt of as necessary when the war began; and at the same time there had been an appreciable improvement in the standard of living of the working classes.

These things had not been done without making considerable drafts on our capital resources. We had borrowed abroad, though not nearly as much as we had lent to our Allies.

We had sold perhaps a thousand millions' worth of the investments which our thrifty forefathers had made in the previous century, by lending money to foreign Governments, by financing the building of railways abroad, and by generally stimulating the production of the whole world by providing it with capital We had also seriously impaired the efficiency of our industrial and distributive machinery, by being unable, largely owing to lack of labour and material, to maintain the usual rate of maintenance and up keep that is year by year put into our industrial plant under the item of depreciation

But after making allowance for all these facts, which account for much of the apparent economic miracle that we had worked during the war, it still remains true that we had shown that there were capacities and powers in this country, and in others, which had not been fully developed in the pre-war period Perhaps this was because for the first time since the industrial revolution, machinery had been allowed to do its work as well as it possibly could, unhindered by restrictive regulations on the part of trade unions, and by the desire to control output, in order to maintain prices, on the part of producers and distributors We had worked really hard, some few much harder

than was good for them, nearly all of us a great deal harder than we had before the war, in order to provide the goods and services needed for the defeat of the enemy and the maintenance of the population at home. And the result had been that, in spite of the general belief when the war began that it could not last more than a few months owing to the financial exhaustion that it would inevitably bring with it, it had actually lasted for four years, though the demands that it had made on human production had been immeasurably greater than anybody imagined when it began.

There was then this solid material basis for the dreamings of those who had hoped for a new world when the war was over. Productive capacity was very much greater than anybody had believed, and, since man lives on what he produces, life might evidently have been made more generally comfortable, if, when the war was over, all nations and classes had worked together for production and exchange as well as they had worked together, or against one another, for destruction and slaughter. It was a question of good or bad temper, and bad temper won, as was perhaps inevitable after the trials to the temper of the human race which the war had inflicted on it. Bad temper kept the war spirit alive long after it had done its

work and gave us neither peace nor war but chaos accompanied by a snarling obligato; and so disillusionment and disenchantment have made us look fools who cherished, during and after the war, hopes that the war would have taught us something. But in their day these hopes were not only real, but had as much justification as many of those with which we comfort ourselves. Moreover some of them may yet come true.

Like a trumpet call they stirred the blood of enthusiasts who thought that this was a good time for reforming our monetary system. Common sense with its stuffy conservatism might suggest that we should first restore our credit machine to its old-time health and efficiency, and then see what could be done towards improving it. But this humdrum policy did not commend itself to the many critics who had always complained of its inelasticity and rigidity. The attack was opened by the late Sir Edward Holden, in his speech to the Shareholders of the London Joint City and Midland Bank, on January 29, 1918. He called the admiring attention of his audience to the principles on which the United States had arranged their monetary system under the new Federal Reserve Banks. Before doing so, he stated that he wished to

congratulate the Federal Reserve Board and the bankers of America on having succeeded in creating and building up a banking system which "surpasses in strength and in excellence any other banking system in the world." He showed that before the Reserve System was established national banks in New York, Chicago and St. Louis were required to maintain a minimum ratio of cash to liabilities of 25 per cent. "Under the new system the minimum was reduced to 18 per cent., and in June 1917 by an amendment to the Federal Reserve Act the required ratio was further reduced to 13 per cent. It was also provided that this minimum legal reserve of 13 per cent. should be held as a deposit in the Federal Reserve Bank, as against 7 per cent. formerly, and that cash in the hands of national banks in these cities should no longer rank as legal reserve for the purpose of calculating the ratio." These measures, as Sir Edward observed, very greatly increased the deposits and gold reserves of the Reserve Banks; and he added that, just as the Germans foresaw the alterations that were necessary in their banking law, and proceeded to make them without hesitation when war broke out, so the Americans have not hesitated to make alterations in their banking law since they joined the Allies in the war.

The fact that really roused his enthusiasm, when he contemplated the Federal Reserve system, was the huge possibility of expansion that it brought with it.

After analysing the balance sheet of the Federal Reserve Banks, "Let us see," he said, "how much further the banks can extend their loans and create credits on their present cash reserves. The Law requires the notes to be covered by a minimum of 40 per cent. in gold, and the deposits by at least 35 per cent. in gold or lawful money. By reducing the present ratios to the legal minima of 40 per cent. and 35 per cent. respectively, the Reserve Banks would be able to create additional loans for member banks to the extent of about £400,000,000. These additional credits of £400,000,000 would form the base for the creation of additional loans and credits by the member banks of over £3,000,000,000, thus placing them in a position of being able to assist to a marvellous extent in the financing of the industries and any future War Loans."

Certainly, if the creation of more banking credit really makes it possible just by book-keeping entries in the banks of a country to increase its wealth and happiness, the system of the Federal Reserve Board seemed to offer most attractive possibilities; and as will be

shown later, their came a time in the after-war period when those who maintain this simple proposition that continued multiplication and consequent depreciation of the currency really tends to a country's prosperity, in other words that bad money makes us all rich and happy, really had some practical experience to which they were able to point as bearing out this view; and the question whether bad money pays is one which will have to be quite seriously discussed before we have done with the subject.

Sir Edward Holden, of course, would not have admitted that the huge expansion made possible by the Federal Reserve system would have involved anything like bad money, even if it had been carried out to its full extent. He proceeded to argue that since Germany at the beginning of the war altered her Bank Act, and during the war America altered hers, we should do the same thing and repeal the Bank Act which, he said, "has been notorious for increasing our troubles" and has had to be suspended on four occasions. The rather relevant fact, that the last date before the war on which the Act had been suspended was in 1866, he did not mention. The principles for which he contended are those on which other national banks of issue, according to his

account of them, worked. These principles are:—

"1. One bank of issue not divided into departments.

"2. Notes are created and issued on the security of bills of exchange and on the cash balance, so that a relation is established between the notes issued and the discounts.

"3. The notes are controlled by a fixed ratio of gold to notes, or of the cash balance to notes.

"4. This fixed ratio may be lowered on payment of a tax.

"5. The notes should not exceed three times the gold or the cash balance."

It will be seen that on these principles indefinite expansion can be secured. The basis of your note issue is not to be as it was in our case before the war—gold except for a fiduciary issue, the amount of which was fixed—but bills of exchange with a certain proportion of gold (one-third in Sir Edward's view), which proportion, again, can be reduced apparently at will by the payment of a tax. Thus, if the community will only draw enough bills of exchange and pay a certain amount of tax, it can have as much *legal tender currency* as it thinks it wants. Much was said, in the discussion that Sir Edward's proposal aroused,

about the beauties of the bill of exchange as a "self liquidating" instrument; and it is true that a bill drawn on a solvent acceptor against goods on the way to market has outstanding merits as a short investment. But it was not quite right to assume, as happened, that currency based on bills of exchange cannot be multiplied to excess because there must necessarily be goods behind every bill, and so currency could not increase faster than goods. In fact bills are often drawn without goods behind them, on the credit of the parties; and even if it were possible to exclude such kites from being used as the basis of currency it is still possible that several bills might be drawn against one parcel of goods. Goods generally change hands many times on their way from the producer to the final consumer and if they are paid for each time that they are sold by the drawing of a bill at three months and all these bills could be discounted at the Bank and new notes created against them, a ship load of cotton or copper might easily have ten times its value in notes outstanding on its responsibility. And sometimes when goods do not find a final market bills drawn against them are renewed; and when this does not happen there could always be fresh batches coming forward produced in the same way.

Under these arrangements, if carried to their logical conclusion, the task of those who have to maintain the country's gold reserve, on the assumption that a gold reserve is a necessary basis of a monetary system, would be extremely difficult. In one of its exuberant moods the commercial community could demand the creation of fresh currency as fast as it liked, continually forcing up prices, and so putting further nominal profits into its pocket as the process continued. The question of the effect of such a development on the foreign exchanges is a consideration which any individual producer might consider less important than the maintenance of activity and rising prices which were making his profits look so comfortable, and enabling him to make everybody happy by maintaining and increasing the employment that he was giving. The arguments for a Paradise based on unlimited credit expansion are extremely attractive, as long as one does not look at the end of them. The end, when the system is worked to its logical conclusion, has been shown in Russia, and other countries where the currency has become practically worthless.

As it happened, at the very time when Sir Edward was making this attack upon the old system on which the country's monetary

arrangements were based, a Committee had already been appointed under the Chairmanship of Lord Cunliffe, who was Governor of the Bank of England during the early period of the war, to consider "the various problems which will arise in connexion with currency and the foreign exchanges during the period of reconstruction, and to report upon the steps required to bring about the restoration of normal conditions in due course," and the following words were subsequently added to the terms of reference:—"and to consider the working of the Bank Act of 1844 and the constitution and functions of the Bank of England with a view to recommending any alterations which may appear to them to be necessary or desirable."

This Committee signed on August 18, 1918, its first interim report which was, in fact, the most important document that it produced. It practically recommended that the Bank Act of 1844 should be restored to full working order, with very slight modifications to meet the altered conditions. It did not admit any need whatever for altering the principles on which the Bank Act had been based.

After giving an interesting survey of the currency system before the war, in which it rather ignored the difficulty which, since the introduction of the Act, the Bank of England

had experienced in maintaining its control of the market; and having touched on the changes which have affected the gold standard during the war, laying stress on the great increase in the volume of bank deposits and of legal tender currency; and pointing out that these issues could not be avoided, "given the necessity for the creation of bank credits in favour of the Government, for the purpose of financing war expenditure;" it then proceeded to discuss the measures for the restoration of conditions necessary to the maintenance of the gold standard.

"It will be clear," says the report, "that the conditions necessary to the maintenance of an effective gold standard in this country no longer exist, and it is imperative that they should be restored without delay. After the war our gold holdings will no longer be affected by the submarine danger, and it will not be possible indefinitely to continue to support the exchanges with foreign countries by borrowing abroad. Unless the machinery which long experience has shown to be the only effective remedy for an adverse balance of trade and an undue growth of credit is once more brought into play, there will be a very grave danger of a credit expansion in this country, and a foreign drain of gold, which might jeopardize the converti-

bility of our note issue and the international trade position of the country."

It will be noticed that in this and many other passages in the Committee's Report, it assumes that the right to export gold, which was ostensibly still existent during the war, would be maintained. This is an important point to bear in mind, because the trade depression of recent years is often laid at the door of the Cunliffe Committee and the policy that it is alleged to have recommended. In fact the right to export gold except under licence was abrogated by law in the Spring of 1919, and by this measure the whole basis of the policy of the Cunliffe Report was cut away.

The Committee proceeded to recommend that Government borrowings should cease at the earliest possible moment after the war, and that as soon as possible repayment should be begun of a large portion of the enormous amount of Government securities held by the banks. It accordingly recommended that at the earliest possible moment an adequate Sinking Fund should be provided out of revenue, so that there might be a regular annual reduction of capital liabilities, more especially of those which constitute the Floating Debt, and it went out of its way to remark that it was of the utmost importance that such repayment should not

be offset by fresh borrowings for capital expenditure, that it was essential to the restoration of the effective gold standard that the money for such expenditure should not be provided by the creation of new credit, and that, in so far as this expenditure was undertaken at all, it should be undertaken with great caution, that this caution was particularly applicable to far-reaching programmes of housing and other development schemes. "The shortage of real capital must be made good by genuine savings, it cannot be met by the creation of fresh purchasing power in the form of bank advances to the Government, or to manufacturers under Government guarantee or otherwise, and any resort to such expedients can only aggravate the evil and retard possibly for generations the recovery of the country from the losses sustained during the war."

"Under an effective gold standard all export demands for gold must be freely met." This observation once more shows that the Committee's whole basis was free export of gold. It went on to point out that some machinery must exist to check foreign drains when they threaten to deplete the gold reserves; that the recognized machinery for this purpose is the Bank of England discount rate; and that when the exchanges are adverse, and gold is being

drawn away, it is essential that the rate of discount in this country should be raised relatively to the rates ruling in other countries. It also sat heavily upon the suggestion that the differential rate for foreign money might be maintained after the war, so that money might be made cheap during the reconstruction period for the purpose of home development. Obviously, this differential rate was a war-time measure, which could not possibly be worked or justified under normal conditions.

The Report then went on to discuss the question of limitation of note issue, pointing out that it had been urged in some quarters that in order to secure the provision of a liberal supply of money at low rates during the period of reconstruction further new currency notes should be created, " with the object of enabling banks to make large loans to industry without the risk of finding themselves short of cash to meet the requirements of the public for legal tender money." This also, as the Committee very easily showed, was incompatible with the maintenance of an effective gold standard.

It next proceeded to consider the particular machinery in regard to the control of the note issue, and what modification, if any, might be desirable in the system in force before the war. In the first place, it considered that, though the

England a control over the bullion market rather inconsistent with London's old claim to be a free gold market.

The most interesting part of the Cunliffe Report, however, was that in which it, in effect, answered Sir Edward Holden's criticisms and discussed the changes that he recommended. It did not mention Sir Edward by name, but observed that the Committee had carefully considered various proposals laid before it concerning the basis upon which the fiduciary note issue should in future be fixed. It had been urged that under the rigid restrictions of the Act of 1844 a famine of legal tender money might ensue, and that it was consequently desirable that these rigid restrictions should be transformed into something more elastic, and that the following principal proposals, either separately or in combination, had been put before it by various witnesses:—

"1. That the Banking and Issue Departments of the Bank of England should be amalgamated.

"2. That the issue of additional notes instead of being required to be covered pound for pound by gold should be freely allowed, subject only to the condition that a prescribed percentage of the total issue should be so covered.

"3. That while either an absolute figure for the maximum fiduciary issue, or a maximum determined on a proportionate basis, should be prescribed by law, provision should be made for increases beyond this maximum on condition of a tax being paid by the bank to the Government."

These suggestions the Committee proceeded to discuss, dismissing the proposal for the amalgamation of the two departments of the Bank of England on rather curious grounds. It argued that the effect of the amalgamation of the two departments would be to place deposits with the Bank of England in the same position as regards convertibility into gold as is now held by the note. Presumably there must be something in this argument, or the assembly of very learned and practical gentlemen who signed the Report would not have put it forward; but to the ordinary mind it seems to have very little validity. At present any depositor in the Bank of England can go and draw out his balance in cash, if he desires to do so. In normal times the bank will presumably give him notes or gold to suit his convenience. If the bank exercised its right of paying him in its banking department in its own notes, all that he would have to do would be to go to the issue department and turn the notes into gold.

In the opinion of the Committee it is desirable that the issue of currency, by which presumably they mean legal tender currency, should be subject to strict legal regulation, wherein everybody will agree with them. If a nation says that a certain kind of money must be accepted by all creditors in payment of all debts, it certainly has to see to it that that currency is made as good as regulation can make it. But the Report went on to say that the management of banking should be left as free as possible from State interference. Here also it will carry with it the opinion of the great majority of people, especially since experience during and since the war has had the effect of disgusting most people with the results of Government control of everything. But naturally State socialists and others who believe in State control are in favour of putting the whole banking machinery into the hands of the Government, and this is now said to be one of the recognized planks in the platform of the Labour Party. Continental experience, however, seems to show that the last thing which Socialist Governments do is to nationalize anything.

The Committee stated its belief that the amalgamation of the two departments would inevitably lead in the end to State control of

the creation of banking credit generally, "a contingency which we are convinced would actually hamper the elasticity and efficiency with which the banks are able to meet the requirements of industry." It is rather difficult to see why the amalgamation of the two departments of the Bank of England should necessarily promote the institution of State control over the creation of credit, but, as has been said, most people will agree with the Committee's view that any such control would have a hampering effect. It is, in fact, very difficult to rouse much enthusiasm on either side concerning this question of the amalgamation of the two departments of the Bank of England. Their existence makes the Bank of England's return rather clumsy and eccentric, but the mere amalgamation would not make the return any more illuminating, unless it were accompanied by very great modification in the direction of more detail and fullness. On the whole it may be said that since the return has been published in its double form for more than three-quarters of a century, and since the proposed change would increase the difficulties of those who have to use it by way of statistical record and would produce little or no practical result, there is a good deal to be said for leaving the statement in its old form.

The much more important question of allowing the issue of fiduciary notes without limit, subject only to a fixed percentage of the total issue being held in gold, was argued as follows by the Committee. "If," it said, "the actual note issue is really controlled by the proportion, the arrangement is liable to bring about very violent disturbances. Suppose, for example, that the proportion of gold to notes is actually fixed at one-third and is operative. Then, if the withdrawal of gold for export reduces the proportion below the prescribed limit, it is necessary to withdraw notes in the ratio of three to one. Any approach to the conditions under which the restriction would become actually operative would then be likely to cause even greater apprehension than the limitations of the Act of 1844." It therefore unanimously decided that there were substantial objections to basing the note issue of this country on any proportionate holding of gold.

With regard to the plan of fixing a maximum absolute limit subject to the condition that this limit might be exceeded on payment of a tax, the Committee argued that unless the tax were fixed at a sufficiently penal rate to secure that the normal fiduciary issue is not exceeded except in the circumstances of real emergency,

and then only for a strictly limited period, the system might afford dangerous possibilities of excessive speculation and lend itself to the development of crises which more stringent safeguards might have averted altogether.

Criticism on these lines had often before been applied to the German plan and also to the arrangements recently adopted by the United States. The Committee pointed out that the latter had not yet been tested by experience, and that it was impossible to say how they would actually operate. Certainly most people will agree that the argument from the experience of the Federal Reserve Board of the United States is not yet one which could be admitted as a practical one for English purposes. Since the Federal Reserve Board came into existence America's financial position has been quite abnormal, owing to the huge profits that were poured into the country by the clamouring demand of the warring powers for goods and services that America was able to produce at an enormous profit to herself. In payment for these goods and services a mountain of gold has been piled up by the United States, and the chief pre-occupation of the Federal Reserve Board now appears to be to prevent the expansion of credit which this great addition to the country's gold store makes possible and would

have brought into being if its effect had not been checked by deliberate control.

The Committee also observed that, in view of the comparison with the systems prevailing in foreign countries which have been put forward by various witnesses, it wished to point out that these countries did not in practice maintain the absolutely free gold market which this country by reason of the vital importance of its position in international finance was bound to do.

It then summed up strongly in favour of the old system—absolute restriction of legal tender *except in so far as it could be increased by an* addition to the gold stock of the country by imports from abroad. In doing so it decided in favour of a policy which is naturally disconcerting to bankers, producers and distributors in so far as they regard their own convenience merely. Those who want to do business and finance business could do so much more comfortably if it is always possible to expand the supply of currency and credit whenever their convenience makes it desirable to do so. On the other hand unlimited expansion when carried to its logical conclusion produces economic chaos, and therefore obviously some sort of regulation is essential. The convention by which mankind used the precious metals

as a medium of payment imposed the rough and ready regulation arising from the limit on their supply. By the use of paper money convertible into metal, it has been possible to combine this regulation with great expansion and elasticity; and as long as convertibility is retained as the foundation stone of the monetary edifice, the only question that is open to argument is the extent to which this expansion and elasticity should be allowed to proceed.

Sir Edward Holden wanted a greater degree of expansion to be secured by a note issue, not limited absolutely by the amount of gold in the country, but expanding in proportion to the amount of gold. As the Committee was able to show, this system, if really effectively working, raises possibilities of disturbance and dislocation much greater than under the system of an absolute limit. With an absolute limit as we had before the war, if a million pounds' worth of gold is taken from the Bank of England a million pounds' worth of notes have to be cancelled. Under Sir Edward's proposal of a three to one proportion, if a million pounds' worth of gold were exported three million pounds' worth of notes would have to be cancelled. The Committee were surely right in pointing out that the apprehension of this

possibility would be very much more disturbing to the business community.

Sir Edward's further suggestion that the proportion of gold to notes might be lowered by the payment of a tax takes away regulation altogether, except the regulation implied by expense, which at times of exuberant gaiety or desperate need is a negligible consideration; this system allows the community to insist on the creation of legal tender currency to any extent that it is prepared to pay for.

On the whole it seems that the arguments used by the Committee in favour of the absolute limit have a balance in their favour, especially when we remember that by the altogether uncontrolled right of the Bank of England to create credit in its books for any borrowers to whom it chooses to lend, and the convention which allows the other banks to regard a credit at the Bank of England as "cash," the apparently hard and fast restrictions of the Bank Charter Act have been made much less tyrannical in their working than they might appear to be on paper to those who do not understand the true inwardness of the British monetary system.

Having thus decided in favour of the maintenance of the principle of the Act of 1844, the Committee proceeded to recommend that the

Act should be modified so as to make provision for the issue of emergency currency in times of acute difficulty, and it came to the conclusion that the provisions of the Currency and Bank Notes Act of 1914 should be continued in force, under which the Bank of England may, with the consent of the Treasury, temporarily issue notes in excess of the legal limit. Thus, instead of the Bank of England being unable to issue any uncovered notes beyond the statutory limit without breaking an Act of Parliament, and consequently having to get a letter from the Chancellor of the Exchequer promising them that he would secure for them an indemnity from Parliament for so doing, they will in future only have to get the consent of the Treasury. There seems to be very little real meaning in this alteration, seeing that under the existing system the Chancellor would naturally not meet the request of the Bank of England for the power to break the law, without consulting his official advisers at the Treasury. This change is therefore merely one of form rather than of principle. The essential thing is that before the Bank can break the statutory limit it will still have to get permission from Whitehall. This necessity, we may be sure, it will move heaven and earth to avoid.

The Committee also observed that it will of course be necessary "that the Bank Rate should be raised to and maintained at a figure sufficiently high to secure the earliest possible retirement of the excess issue." It will be remembered that before the war began the nerves of the public, already quite sufficiently harassed by the closing of the Stock Exchange and other untoward events, were disagreeably startled by a sensational rise in the Bank Rate from 4 per cent. to 10 per cent. in the course of a week. This was because according to precedent the Bank Act could not be suspended without a 10 per cent. Bank Rate, and so, though the rise in Bank Rate did not do anybody any good at the time, and had not the smallest effect in checking demands for credit, it had to be carried out, in order to fulfil the requirements of the dreamy archæologists in whose eyes it was above all important, when Europe rocked, that a monetary crisis should be carried out strictly according to precedent and with due observance of the ceremonial hallowed by tradition.

After prolonged calculations the Committee came to the conclusion that the normal minimum amount of the central gold reserve to be aimed at in the first instance in the after-war period should be £150,000,000—an amount

which was at that time already practically available in the hands of the Bank of England, the currency note department and of the other banks—and that until this amount had been reached and maintained concurrently with a satisfactory foreign exchange position for at least a year, the policy of reducing the uncovered note issue as and when opportunity offered should be consistently followed; that the currency note issue should be finally replaced by a Bank of England issue, but not until the future dimensions of the fiduciary issue had been ascertained; that during the transitional period the issue should remain a Government issue, but new notes should be issued, not against Government securities, but against Bank of England notes; and furthermore that when opportunity arose for providing cover for existing uncovered notes, Bank of England notes should be used for this purpose also. Demands for new currency would then fall in the normal way on the banking department of the Bank of England. Finally, when the fiduciary portion of the issue had been reduced to an amount which experience showed to be consistent with the maintenance of a central gold reserve of £150,000,000, the outstanding currency notes should be retired and replaced by Bank of England notes of low denomination.

Just after the issue of the Cunliffe Committee Report another important Report was produced by a Committee appointed at the end of 1917 to consider whether the normal arrangements for the provision of financial facilities for trade by the existing banking and other financial institutions would be adequate to meet the needs of British industry during the period immediately following the end of the war, and, if not, by what emergency arrangement they should be supplemented. This Committee's report was dated November 21, 1918, and it made some interesting observations concerning the working, not of our monetary system as a whole as regulated by the Bank Charter Act, but of our banking system in its relation to the provision of the needs of its customers for credit.

"Having regard," it said, "to the fact that the very great expansion in credit which has taken place during the war will probably persist for a considerable period after its termination, we are unanimously of opinion that, if the reconstitution of industry and commerce is to be achieved on permanent and sound economic lines, some restriction must be imposed at as early a date as possible upon the creation of additional credit by the restoration of an effective gold standard. To attempt to re-build

industry by means of a further indiscriminate expansion of credit would not only endanger our position as the financial centre of the world, but would inevitably lead before long to grave disaster."

It also laid stress on the need for the immediate cessation of State borrowing after the end of the war. It pointed out that commercial capital issues had been largely in abeyance since the beginning of the war, and that consequently there would be a very heavy demand by trade and industry for new capital, and that State borrowing could only be undertaken in competition with these demands. It further expressed the opinion that any Government guarantee to bankers to enable them to provide by means of credit the fixed capital expenditure necessary for the re-constitution of industry was undesirable as being likely to cause a further expansion of credit, together with an additional rise in prices.

This Committee by laying down these principles thus took a firm stand against the many prophets who were proposing to lead us into a new economic Paradise, merely by the unlimited expansion of credit. It pointed out that for capital purposes what was required was not credit but capital, and that capital could best be provided, not by making entries in the

books of bankers, but by somebody saving money and handing it over to industry to be used for purposes of development. As to banking facilities, it defined them as the normal requirements for carrying on the ordinary business of the country, "which assumes the granting of loans which do not constitute a lock up of funds such as would impair the liquidity of the resources of the banks." For this purpose it was informed that the banks would be able to provide all the necessary facilities during the transition period. In fact, only the most embittered critics of the English banking system have maintained that it showed any inability to provide credits of this kind, that is to say, real banking credit involving no long lock up. His more moderate assailants have only charged the English banker with being too much inclined to insist on confining his activity to this kind of business, though it is clearly the right business for a banker who has an enormous amount of liability in the shape of current and deposit accounts, which may be called from him on demand or on short notice. For such a banker to indulge in giving long credit and so locking up his funds in enterprises which cannot be called liquid is clearly a policy involving very great danger. The critics of the English banks have never been tired of

proclaiming that the German banks, for example, have been able to assist industry much more readily and extensively than their English rivals, by making advances to it on terms which were not strictly of a banking character, according to English ideas. The German banks work with their own capital, as opposed to their customers' deposits, much more than the English. In so far as they do so they are not doing what we call banking, the essence of which is that you borrow money, repayable practically at call, and lend it. Lending shareholders' money which you have got for all time is quite a different business.

This contention was dealt with and to a certain extent admitted by the Financial Facilities Committee. Under the heading of Extended Credit Facilities it included "loans involving a lock-up of funds for a more or less extended period and secured upon assets not readily realizable, including loans required for giving long trading credit, either at home or abroad, and loans secured against capital goods which are either dependent upon future profits for repayment, or will be replaced ultimately by an issue of new capital."

It considered that the banks as at present constituted, however willing they might be, would only be able to provide credit of this kind to

a limited extent owing to the necessity for keeping a large part of their funds in a liquid state It accordingly suggested that it would be necessary for the banks "to exercise discretion upon rather broader lines," and in order to enable them to do this with some safety and confidence, it was strongly of opinion that the banks should make a considerable increase in their paid-up capital The Committee also made the curious suggestion that bankers should make more widely known their willingness to accept deposits for long periods at fixed rates of interest, and expressed the belief that if they were encouraged to do so a number of depositors would be willing to deposit their money at fixed rates of interest at periods of from one to five years without the right of withdrawal

Presumably the Committee had some good ground for making this statement, but it seems that any depositor who was asked to lock his money up definitely for five years, during which time he would have no opportunity of getting his cash back in case of an emergency, unless somehow or other a market could be established in bankers' deposit receipts, would think twice or thrice before he did so The Committee also considered that the principal manufacturing establishments of the country should

increase their capitals by appeals to the public for subscription, thus enabling themselves to rely less upon banking credit for their operations. But, besides all this, it thought that institutions to provide additional assistance for trade and industry by developing similar facilities to those which have been given by the German banks were necessary. In this connection it noted the formation of the British Trade Corporation, whose career has since provided the City, always suspicious of semi-official enterprise, with some malicious satisfaction. Launched on a career of expansion in the after-war fever, with no solid mass of sound old business to lean on, with no hidden reserves to be used for concealing unfortunate slips, it showed some considerable losses when the fever gave way to anæmic debility.

The Committee also made some sound and practical suggestions for an improvement in the machinery for promoting enterprise, and offering for public subscription new issues of capital. It pointed to the machinery already in existence, consisting of a group of financial houses, comprising investment trust companies, well-known issuing houses, merchant bankers and others, and it thought that it was within the power of this important group to render further assistance by identifying themselves with pro-

ductive industries in this country, and rendering financial support in the early stages of development, ultimately undertaking the placing of the issue of new capital with the investor, and that the institution of a system of working arrangements between the members of this group and the various joint stock banks would be of great assistance

These two documents, the Cunliffe Report and the Financial Facilities Report, thus pointed the way back to sanity in money matters along safe and cautious lines In effect they told the Government to leave off the manufacture of new currency and credit and to re establish our legal tender currency on the foundation laid by the Bank Act of 1844, and they told industry that the capital that it required should be found through the process of saving and investment instead of through the extension of bank credits But they were very far from preaching drastic deflation and rapid contraction of credits The Financial Facilities Report, as quoted above, only urged "some restriction" upon the creation of additional credit The Cunliffe Report spoke of an "interim period beginning after the completion of demobilization, during which it is probable that the present issue of Currency Notes will have to be gradually reduced" It

referred to a suggestion put before it in evidence that the uncovered issue should be reduced at the rate of not less than 3 per cent. per annum of the outstanding amount, and doubted whether it would be possible to work to any precise rule. It concurred however in the suggestion that, when reductions have taken place, the actual maximum fiduciary circulation in any year should become the legal maximum for the following year, subject only to the emergency regulations already described, by which in future what used to be called suspensions of the Bank Act would be carried out with the permission of the Treasury.

The Cunliffe Report was dated August 15, and the Financial Facilities Report November 21, 1918. Thus by the time the Armistice came a body of sound doctrine was in existence, reminding us of some of the common sense facts that had once been regarded as platitudes, but had been lifted into the position of almost forgotten ideals by the financial crimes and futilities committed by our War Governments.

CHAPTER IV

THE AFTER-WAR BULGE AND COLLAPSE

It need hardly be said that the doctrine preached by the Cunliffe Committee and the Financial Facilities Report was not put into practice as soon as the war was ended. This could not have been expected, even if war's strained excitement had not been followed by an outburst of peace hysteria that was perhaps still more virulent. If we had all been sane and sober as judges, it would have taken some time to adjust our financial system to the circumstances involved by the rearrangement of industry on a peace basis. As it was there was an amazing outburst of political and economic optimism, followed by violent reaction; and these changes of sentiment were accompanied by monetary measures the effects of which are of special interest for the light that they throw on a monetary theory which has since become fashionable.

For this reason it is necessary to remind our-

selves of the outlines of this curious and interesting chapter in our history.

As everyone knows the war was followed by a spell of delirious trade activity accompanied by a violent rise in prices, high wages, large profits and rampant extravagance on the part both of the Government and of the individuals composing the nation. The consequent collapse came much sooner than was generally expected and was so violent and headlong in its course that it left most of our financial institutions amazedly gasping at their own dexterity, or good fortune, in having survived it. It is easy to be wise in the light of what has since happened concerning the folly of the behaviour of most people during the after-war period, but in fact it was just a very human and natural reaction after the strain of the war, quickened and exaggerated by the promises held out by the Government during the General Election of 1918. During the course of this contest the country was persuaded that, if the Government which had won the war were returned to power, it would secure a just peace under which Germany up to the limit of her capacity should be made to pay for the whole cost of the war, that the Kaiser and those chiefly responsible for outrages during the war should be punished and that social and

domestic reform should be carried out with a generous hand so as to make this country fit to be lived in by the heroes who had served it so well on the field of battle.

A great programme of reconstruction was thus to be taken in hand, largely at the expense of our defeated enemies, against whom a strongly vindictive feeling was still prevalent. The old-fashioned English habit of hammering your enemy as hard as ever you can when fighting, and then, when you have beaten him "thorough and thorough," of picking him up and shaking his hand and letting him off much too lightly was gone, except in the minds of a small minority, and had given place to a feeling of lingering hostility and vindictiveness.

Here again we have to remember the special circumstances of the war out of which we had emerged. Former wars had been fought by a comparatively small number of the population of countries engaged, with comparatively little interruption to the ordinary life of the greater part of the nation. This time the horrors of war had been brought home to nearly every inhabitant of the countries concerned owing to the enormous number of the combatants engaged and the consequent bereavement and loss spread over the whole population owing to the high proportion of casualties, also by the

privation inflicted even upon the most prosperous members of the community by the impossibility of securing many comforts, necessaries and luxuries to which they had usually been accustomed, and finally by the effect of air raids which had inflicted actual physical suffering upon many civilians who had risked their lives without the satisfaction of being able to feel that they had a chance of endangering somebody else's. For these reasons it was evidently much more difficult to leave off the war spirit as soon as the war was over than it had been when war was a more or less gentlemanly business, with its most uncomfortable effects largely confined to the fighting forces, which at least had the pleasure of inflicting what they suffered. Moreover it was felt that the Germans in the matter of poison gas and many other things had introduced new and unnecessary beastlinesses into war, and that the destruction—much of it quite wanton—wrought by them in France and Belgium made it essential in the interests of international justice that retribution should be strict and severe.

Thus justice and vindictiveness joined together to show that Germany ought to pay every penny that could be wrung out of her. It is true that the Allies had agreed, before

granting the Armistice, that the indemnity was only to cover damage to civilian property by land, sea and air. But legal ingenuity combined with poetic imagination in following out chains of consequential damage due to consequential losses and so *ad infinitum* could evidently put as many noughts on to the bill as would suffice to appease the groundlings. Nevertheless the inclusion of the cost of pensions in the Reparations bill always seemed to me to be an ugly blot on the scutcheons of the Allies; though it has been supported by authorities whose judgment and integrity are above question.

For this vindictiveness against the beaten enemy, un-English as it was, there was, as has been shown, a good deal of excuse, but the amazing thing is that there was so little readiness to show more forbearance to our Allies. On this point I am not, as we say in the City, "jobbing backwards," for before the end of 1918 I expressed in print the view that it would be a generous act, which would cost us nothing, to clean the slate of international indebtedness as far as we could by wiping out the whole of the debts due to us from our Continental Allies. They were poorer than we when the war began, had suffered much more from the war, were most unlikely ever to pay us a shilling, and if

they did, would do so with a sense of grudging injustice that would embitter their hearts against us. If our Government had only then had the sense to make a bonfire of the promises to pay of our Allies, they would not have cost us a stiver and they would have made a gesture of generosity which would have had a quite immeasurable effect on the economic atmosphere in Europe, in America, in the rest of the world and at home in England.

As it was, the fashionable sentiment, both in international affairs, home politics and in industrial matters, favoured getting as much as possible out of anybody who could be squeezed. Abroad this sentiment was one of the reasons why it took a most unconscionable time to put together a Peace Treaty, which when it was put together produced anything but peace, and that the Reparations problem developed into that dreary mixture of tragedy and farce of which more will have to be said later.

At home the Government instead of telling us, what it ought to have known if it did not, that in some ways the most difficult part of the war began when it was over, encouraged us in the belief, already much too prevalent, that the country's wealth was unlimited and there was a bottomless purse into which everybody could dip for the purpose of carrying out any reform

that he thought desirable for himself or for the community apart from any question of the energy and efficiency with which the community did its work. It has been shown above that the war revealed a quite astonishing capacity for production on the part of this country when the working power of the community was really set to work as hard, or nearly as hard, as it could. Under these circumstances we had apparently performed economic miracles, and the very dangerous delusion was rife during the after-war period which taught that economic miracles could be continued without the tremendous effort and whole-hearted co-operation which had marked our productive achievements during the war. If the land was to be made fit for heroes to live in, it could only be made by a continuance of the hard work and goodwill which had made it victorious during the war. The assumption that it could be done at the expense of some fund already in existence and that the rock only had to be struck hard enough in order to produce a stream of prosperity led the working classes of this country along a path which ended in grievous disillusionment.

It was shown only too clearly that the Government's purse very soon reaches bottom unless it is filled by a stream of goods and

services provided by the community or by some foreign lender or debtor. We had ceased to borrow abroad and Germany had not begun to pay. It was not really possible for us all to be happy and prosperous by deciding not only to work shorter hours but also to work with much less enthusiasm during the time we spent at our job, and by also insisting on the restoration of many regulations and controls which before the war had hindered the output of industry. A system under which each worker, while making a smaller contribution to the general output, should at the same time receive a larger share of it in return for his lessened work was really too good to be true. These platitudes had to be brought home to the working-class community through a series of disastrous industrial disputes which very seriously hindered the economic recovery of the country.

Here, again, the accusations freely brought against the working classes of some special spice of villainy or of an abysmal ignorance of economic conditions are by no means justified. The inferences that they drew from their war experience were quite reasonable and natural. With the country engaged in a fearful and costly struggle, they had seen a very large number of the employing class amassing

enormous profits in spite of taxation designed to prevent their doing so; they had seen amazing things happen in their own class, as when one member of the family faced all the hardships and dangers of exposure and of warfare in a mine sweeper, for pay which left him very little better off than an ordinary seaman before the war, while his brother or his cousin who stayed at home because he was not physically fit to fight, earned wages which may have ranged from £15 to £20 a week in a munition factory, or, if he happened to be a shopkeeper, might amass a fortune which enabled him to start a county family. Such had been some of the economic effects of the war, contrary to all logic or common sense, and largely due to bad war finance.

It is not to be wondered at that having seen such things before their eyes the working classes of the country should come to the conclusion that practical sense did not count in money matters, and that anything was possible for those who only persisted in demanding it with a sufficiently loud voice. They believed, and with good reason, that immeasurable economic injustice had been inflicted during the war especially upon the best men of the community who were fighting its battles at the front; and they argued that it was at any rate

worth trying whether they could not, by insisting on a larger share of the national output in return for much less work, put some injustices right by securing for those who did the hard, dirty and uninteresting work of the world a better share of the goods which they helped to produce. They had to find out by bitter experience that it is only by increasing output and making trade prosperous that they could make their demands for better conditions felt. But there is nothing strange about economic mistakes made by uneducated folk, at a time when our leaders, who believed themselves to be the fine flower of the nation's intellect, were wallowing up to their eyebrows in economic and political error, and the mighty brains that directed industry and finance were making enormous miscalculations about the staying power of the after-war demand foi goods.

In fact, as we all know, it is human to err; and in the after-war reaction we were all very human indeed and erred with hearty and unanimous vigour, with a few very select exceptions who were not quite human and so did not join in the erroneous orgy. The rest of us, fired by determination to go on beating the enemy after the end of the war, to create an earthly Paradise at home at the expense of

somebody else, to pocket big profits, big salaries or big wages while doing as little as possible to earn them, and generally to have a glorious time because peace and plenty had returned and there were cakes and ale, and ginger, by Saint Anne, was hot in the mouth, naturally and inevitably spent, collectively and individually, extravagantly and recklessly.

Any attempt to balance expenditure and revenue was felt to be unsuited to the atmosphere. The national debt, in fact, went on increasing from the Armistice date, November 1918, until the end of December 1919. Even if Mr. Gladstone and Lord Welby had been in charge of the national finances, it would have been impossible, as soon as the war was over, to bring outlay within income. Very heavy expenses were involved by demobilization of the army and by the problem of returning to ordinary industry the millions of men who had been in the fighting line and in the field or on the lines of communication, or who had been employed directly or indirectly on work for war purposes. On the whole it may be said that this business of getting the great majority of them back into ordinary industry was carried out with astonishing rapidity and success, for which the Government, in the midst of the chorus of criticism

which began to arise under the pressure of disillusionment, did not receive the credit to which it was entitled. And there can be no doubt that official extravagance, commercial recklessness and miscalculations, private profligacy and the inflation that they all helped to produce, at least did something to ease and quicken the work of demobilization in the widest sense of the word, and the adjustment of industry from war to peace conditions.

So much had to be said about the temper and sentiment that ruled in the after-war period, because their effect upon the monetary matters which are the subject of this inquiry were like Sam Weller's knowledge of London, extensive and peculiar. Under their influence the expansion of currency and credit that have been shown to have been one of the most aggravated symptoms of bad war finance, continued with quickened inflammation, produced at once by the needs of a spendthrift Government, the cravings of industry and commerce, intoxicated by the prospect of a world-wide insatiable demand for goods at any price that might be asked, and the clamours of eager consumers, in full reaction from the privations, enforced and voluntary, of the war period. And so prices, after a momentary dip after the Armistice, went rollicking ahead for nearly a

year and a half, before they dropped like a stone in the last three quarters of 1920.

In the Money Market, in the strict sense of the phrase, the outstanding event of the after-war period was the formal abandonment by England of the gold standard in March 1919 by the prohibition of gold exports except under licence. By this measure we went legally and definitely on to the paper currency basis, on which we had actually been standing, or rocking, all through the war. Convertibility of our legal tender currency into gold on demand was and is still the law of the land, but a very interesting example of the enormous power and prestige of the Bank of England is the ease with which on this point it ignores the law and goes scatheless. When a Home Secretary packs off some people to Ireland in the belief that he is acting legally and then finds that he is not, he is made to produce their persons and is put into a very uncomfortable position, from which he has to be rescued by a Bill of Indemnity. When people present a five pound note to the Bank and ask for gold which it is legally bound to pay, it reasons with them kindly and points out the error of their ways, and they go away with no gold in their pockets but a virtuous glow in their hearts, as if they had had their souls shampooed by a bishop.

But, such attempts to get gold, even if likely to be successful, would be quite futile for practical purposes, unless any gold so secured could be dealt with according to the desires of him who gets it. It is of no use to be able to take gold out of the Bank of England unless one can send it abroad, if this happens to be the cheapest method of paying a debt to a foreign creditor. For purposes of hoarding at home it might offer attractions to a few feeble-minded people; but the practical benefit of the gold standard is the fact that thereby you link your currency with those of other gold standard countries and in effect use the same currency as they do. When once the right to send gold abroad is taken away there is no link between the world's currencies, and variations in the price levels in different countries are no longer restrained by the fact that currency can move from one country to another, raising prices in the country to which it goes and lowering prices in the country which it leaves. And it also follows that when once the golden link is snapped, the prices of different currencies as expressed in one another through rates of exchange, can vary down to zero and up to an astronomical zenith.

It was generally admitted that the Government had no choice in making this regulation.

The New York exchange which expresses the sterling price of money in New York had been, as we all remember, "pegged" since January 1916 in the neighbourhood of $4·76\frac{1}{2}$ to the £. This peg was withdrawn in the Spring of 1919 and the American exchange immediately began to move against London owing to the great demand for American goods at high prices, not only in this country but all over Europe—and Europe's demand for dollars was, then as at other times, largely financed through London—and also owing to the rapidity with which inflation was proceeding here. Under such circumstances, since the submarine danger was no longer protecting the English gold standard, it was inevitable that people abroad who had balances in London should want to turn them into gold and send the gold to America to be converted into dollars and so make the handsome profit which was offered by the rate of exchange. English bankers, when these demands for withdrawal came upon them naturally asked the Government what they were to do and the Government met the situation by prohibiting the export of gold except under licence.

Most people thought that it had to be done, but it is interesting to wonder whether it would not have been possible for England to meet

the situation by the good old banking rule for meeting a drain—that is by saying, with a stiff upper lip and an air of calm confidence, "Take your money as fast as you like." It is usually said that if we had attempted to do this all our gold would have immediately left the country and gone over to America; but this is by no means certain. In the first place it could not all have gone at once because even without the submarine danger there are very decided limits to the possibility of insuring gold shipments against ordinary marine risks. It is not possible to dogmatize about this because to a certain extent it is a question of the price that will be paid. I am told by those who ought to know that any shipment of more than £4,000,000 of gold in one bottom would have been very difficult to underwrite in the ordinary course of business in London and other centres, and that the insurance of such a shipment would only have been even considered on a first class liner, of which probably not more than two, and sometimes not so many, would have left a possible port of shipment during a week. Thus the process of draining away our gold supply, which stood at the end of the war at about £150,000,000, would necessarily have been slow. If we had shown that we had meant to allow it, it would certainly have been

a cause of considerable apprehension to the authorities of the United States Federal Reserve Board. They were already embarrassed by the great mass of gold which they had accumulated during the war and by the enormous possibilities of credit expansion which their system allowed to be built up upon this basis. Indeed, it may be said that since the war the Federal Reserve Board has been chiefly anxious to prevent America's huge holding of gold from having its natural economic effect, by producing an enormous expansion of credit and currency and so turning the exchanges of the world against America and driving some of the gold out.

Given a mountain of gold and the American temperament, an outburst of Gargantuan consumption indulged in by the latter might soon be relied on to disperse the former, unless artificial checks had been applied, and such an outburst might have been best in the long run for all parties concerned. But the Federal Reserve authorities working an untried machine along an unknown road, with an extremely suspicious and critical public ready to pelt them if they made a mistake, were not at all inclined to take risks. And big risks would have been involved if they had allowed their gold to work its own cure, through an expansion of credit

and currency, with an orgy of extravagance and speculation and consumption of the goods and securities of other countries, ending in adverse exchanges and exports of gold.

This natural solution of the question being too exciting a "proposition" for the nerves of the Federal Reserve Board, America has had to sit on an enormous mountain of gold while its financial rulers have done their best to prevent it producing the economic results which its presence would naturally have worked. Their task would evidently have been made much more difficult if gold had begun to come from England at the rate of 8 or 10 millions a week; and it is certainly possible that in any case, if England had shown a sufficiently stiff-necked determination to pursue the policy of allowing gold to go, the result might have been a working agreement between ourselves and America by which exchange equilibrium between the two countries would have been maintained at a point which would have prevented a continuance of the drain of gold.

There is, as least, something to be said for the view that the Government, rather than hauling down its colours on the matter of the gold standard much sooner than it need have done, might have tried a bluff and let a certain amount of gold go, and waited to

see what happened. We might possibly have held the gold standard and been brought back, much sooner than we were, to sanity in money matters. As it was, we kept our gold and lost our gold standard definitely though temporarily, when the export of gold was forbidden. At the same time an arrangement by which the output of the South African mines had been taken over by the Bank of England at the mint price was dropped and the market was freed for any gold, for the export of which a licence could be obtained. The consequence of this has been that the gold from the South African mines has gone regularly week by week to New York, except on rare occasions when a demand on account of India or China has diverted a fragment.

Less important changes in the working of the Money Market were the dropping in May 1919 of the system by which the Bank of England borrowed from the Clearing and other banks their surplus cash balances, and later in the same year, in October, the special rate given for foreign money was also dropped. This was a war time measure which could not possibly have been continued into peace. In war time the censorship of telegrams and letters made it more or less possible to trace the actual purpose of financial transactions, and to see that

money which earned the higher rate as foreign, really was so. In peace there was no such safeguard, and in any case the differential rate is not wanted in peace time. It was less wanted than ever in the after-war period, since the movements of credits to and from this country was then largely regulated by movements in exchange which were already sufficiently erratic and violent to make the question of the rate earned by sums left here an almost negligible item in the consideration of those who controlled them.

Attention has already been called to the change in the working of our Money Market that had been produced by the enormous total of the floating debt created during the war. The existence at the end of the war of over a thousand million of Treasury Bills outstanding, of which between £300,000,000 and £400,000,000 were probably in the hands of the banks and other professional dealers in credit, clearly made it difficult for the Bank of England to secure real control of the monetary position If these professional holders of Treasury Bills took it into their heads to want more credit, at a time when the bank wanted them to have less, they had only to present them day by day for payment instead of renewing them on maturity and they could compel the Govern-

ment to create the necessary credit for meeting them by borrowing from the Bank of England on Ways and Means advances and so increasing the amount of cash at the Bank of England held by the other banks.

For this and other reasons it seemed that the volume of outstanding Treasury Bills should somehow be reduced, and with this intention a funding loan was offered in June 1919. All the organization and energy which had been so successfully developed during the war for encouraging subscribers to war loans to lend as much as they possibly could and as much more as they could borrow from their bankers was put into commission to secure the success of the funding loan, but this success was conspicuous by its absence. Already the country was decidedly anxious about the scale of Government expenditure and investors had become imbued with the belief that the only way to make the Government economize was to refuse to provide it with money. They were decidedly sceptical as to whether the sums which they lent would be used for the alleged purpose of reducing the floating debt and openly expressed the opinion that the Government was almost certain to expend it upon other objects. This contention was proved to be almost exactly correct by one of the most

curious arithmetical coincidences on record, namely, the fact that the amount of cash produced by the loan was £473,000,000 and that £473,000,000 was also the amount of the deficit for the financial year, estimated by Mr. Chamberlain in a speech which he made in the Autumn.

This failure of the funding loan was interesting as the first indication of the growing wrath of the taxpayer concerning Government expenditure and the suspicion of investors concerning official promises. This suspicion was increased by a rather absurd attempt to continue war camouflage into peace finance. Mr. Chamberlain's reputation for an integrity quite unusually high among politicians makes it all the more remarkable that he should have brought pressure on the banks to make the success of this loan look much greater than it was, while at the same time impairing its real effectiveness. The result that was really wanted from the loan was that Treasury Bills in the hands of the banks and other official dealers in credit should be paid off out of money genuinely subscribed by the public for that purpose. Yet when the loan was found not to be going as well as was hoped, pressure was brought upon the banks that they should themselves subscribe money out of which their Treasury Bills were to be

paid off with the result that they, instead of holding Treasury Bills, would merely have held a longer dated security. It is true that if they had done so their power to call upon the Government to manufacture fresh money for them would have been reduced; but one of the chief purposes of the loan was to restore order into chaotic money conditions and enable the banks to get back to their real business of financing industry; this was to be done by paying back to them money which they had lent for the war, and this purpose was defeated in so far as the banks themselves were asked to contribute money to pay themselves off with. It was suggested that the banks should underwrite a certain amount of the loan and one of the last acts of Sir Edward Holden, just before he left for the holiday from which he never returned alive, was to refuse to do anything of the kind and at the same time to make application for an amount of the loan which was very much less than the Government had asked him to underwrite. The final result of these proceedings was that out of the £473,000,000 secured by the operation £92,500,000 were provided by the banks.

As the year 1919 went on our rulers began to wake out of the dreams into which they had drugged themselves and the country. In

August Mr. Chamberlain made a speech in the House of Commons in which he called emphatic attention to the unsatisfactory state of the Government finances and went so far as to include the phrase "national bankruptcy" in his sketch of what was going to happen if extravagance in expenditure was allowed to proceed at a pace so much faster than the inflow of revenue. The country was startled and alarmed by the statement, and some of us wondered why, if these things were so, the Chancellor of the Exchequer did not either cut down expenditure or raise fresh revenue But Parliament adjourned with nothing done, and in November there came a rise in Bank Rate and a Treasury Minute. Bank Rate had stood at 5 per cent. ever since the Armistice and was put up to 6 per cent. in November 1919 with a consequent advance in the rate at which Treasury Bills were sold.

The Money Market was bewildered and puzzled by this movement. There would have been no mystery about it if the Government had found any difficulty in selling Treasury Bills at the current rate and so had thought it necessary to offer a higher rate on them; or if large demands for credit had been made on the Bank of England; but in the previous two weeks the securities in the Bank return had

dwindled by £35,000,000, and at the time when the rate was raised Treasury Bills were in fact being sold with quite satisfactory ease, so the effect of putting the rate up was rather to check the demand both for them and for commercial bills, because it was felt that with the Bank Rate rising on this apparently quite illogical system another rise in Bank Rate might happen at any moment. The old reasons for movements in Bank Rate to protect the gold stock, so strongly insisted on by the Cunliffe Committee Report, had all been destroyed for the time being by the prohibition of the export of gold. Consequently, the market had no bearings to steer by in the matter of Bank Rate and could only cherish an uncomfortable feeling that since a rise had taken place when there was apparently nothing special to warrant it, a further rise on equally obscure grounds might be expected at any time. In fact, there was for a time a serious risk of something like panic, because Lombard Street, very naturally under the circumstances, practically retired from its bill discounting business, and a very awkward deadlock was only stopped by special measures taken by the Bank of England, which expressed its readiness to discount sixty days' bills (instead of the customary ten or fifteen days) for the bill brokers if they needed such

accommodation, and otherwise coaxed and wheedled them back to business.

At about the same time a Treasury Minute was produced imposing a limit upon the fiduciary issue of Currency Notes, that is to say on the issue of Currency Notes which were not backed by gold or by Bank of England Notes, this limit being fixed at £320,000,000, in accordance with the recommendations of the Final Report of the Cunliffe Committee. The Treasury had no real power to control the note issue because holders of the Treasury Bills could at any time insist upon their repayment, and could thereby secure either Currency Notes or Bank of England notes or a credit at the Bank of England which they could turn into Currency Notes. Nevertheless the issue of this Minute and the raising of Bank Rate probably had a certain amount of psychological effect and brought home to men's minds a few facts which had been forgotten by many people engaged in finance, industry, commerce and politics; such as, that unlimited expansion of currency and credit was not part of the scheme of the universe, that British industry had worked before the war and with considerable success with a monetary system which had been limited by the amount of gold in the country and that the issue of unlimited paper money—

inconvertible in fact because gold could not be exported—could not be allowed to pursue its riotous way unchecked, unless the country was prepared to face the final result in total worthlessness of the currency.

Thus the Treasury Minute and the rise in Bank Rate, which thus made its first appearance as a sort of moral weapon, to be moved up or down for the good of our souls, were a timely reminder of forgotten truths, but their doctrine had little immediate effect. For several more months extravagance, inflation and hysterical business continued, and when the check came at last in the spring of 1920, it was rather because the pace was too hot for the home and foreign consumer, than because the producer and the merchant were frightened by a rise of a couple of points in the price of money.

In fact, as will be shown, the contraction in credit which is supposed to be caused by a higher price of money and to cause a lower price of goods, did not make its appearance until long after the bottom had fallen out of the price of goods, and some time after the price of money had begun to come down again. Up till the end of 1919 prices and money—as far as we can trace the latter's movements—moved together with a harmony most satisfying to a statistical mind and to constructors of charts

and curves. As the Government continually outran the constable, it created new credit by borrowing directly and indirectly from banks, and new currency was poured out as backing for the new credit and prices went, with occasional slight hesitations, steadily ahead. But after 1919 the disagreements and discords between money and prices are as consistent as the previous harmony and need very careful consideration in view of the fashionable belief that credit, contracted and expanded like a concertina by a consortium of banks of issue, will suffice to draw a nice straight line of stabilization across the once untidily see-sawing price chart of human enterprise.

CHAPTER V

THE COLLAPSE AND ITS CAUSES

DECEMBER 31, 1919 was the real turning point in our war finance, for it was the date on which our rulers went back to the good old habit of providing for expenditure out of revenue. It is true that for some years more they had to be very generous to themselves in their interpretation of the word revenue in order to achieve this feat, because included in their receipts were huge sums realized by the sale of assets that had been bought with money that had been borrowed during the war; and anyone who likes to be pedantic in book-keeping can argue that these sums were not revenue at all but receipts on capital account, the whole of which ought to have been devoted to debt redemption. Whereas, in fact, out of the £724,000,000 received from special receipts during the financial years ending March 31, 1920, 1921 and 1922, only £276,000,000 were available as surplus to redeem debt and the balance went to the relief of taxation.

It was not until the fiscal year 1922-23 that

the amount of debt redeemed was greater than the sum produced by the sale of war assets, and then only by accident. For that was the year in which Sir Robert Horne played a glorious farce with the nation's finances by first proposing, in order to reduce taxation, to pay off debt with borrowed money, and then being smothered by a surplus of £120,000,000, owing to enormous errors in estimating for which he, of course, was not responsible.

But whether the Government paid its way out of revenue, or by selling capital assets, the fact remains that after the end of 1919 it followed the sound doctrine of the Cunliffe Committee and committed no further borrowings, and indeed redeemed debt rapidly. The result was that there was no more expansion of currency and credit due to loans from banks to the Government or to customers who borrowed money to lend to the Government. A certain amount of temporary inflation happened from time to time, especially at dates when very large interest payments had to be made, because the Treasury, being unable to finance its needs out of ordinary receipts or by the sale of Treasury Bills, had to raise money by Ways and Means advances from the Bank of England, so producing an extra supply of "cash at the Bank of England" for other

banks, and expanding not only credit but the basis of credit. But these expansions were soon corrected as revenue came in and the newly made credit was soaked up by the sale of Treasury Bills, and the Bank of England and the Treasury evolved ingenious dodges for modifying their extent and effect. In fact, deflation may be said to have begun by the reduction of the Government's indebtedness to the Bank of England on temporary advances to zero, and by endeavours to keep it there as far as possible. Henceforward if inflation happened, it was not because of bad finance by the Government, but only because of demands for credit by industry and commerce, and other private borrowers.

So here we are at a turning point and may well stop to consider what was the right thing to do with our money in view of the way in which, during and after the war, its buying power had been lessened by the increase in its quantity. Ought it to have been brought back, if possible, to its pre-war value by being drastically and rapidly reduced, or ought it to have been "stabilized"—to use the new word that appeared about this time—or ought we to have joined the ranks of those who quite seriously argued that a depreciating currency is good for trade and makes everybody happy,

that Germany was driving us out of the markets of the world because the mark was falling in value, and that more inflation was the statesman-like prescription?

I think there was a feeling among us men in the street, especially those of us who were hoary headed and old-fashioned. that the British pound of which we had been perhaps ridiculously proud, had suffered a most unworthy outrage at the hands of politicians who ought never to have been allowed to meddle with it, and that it was due to the British pound's dignity to try to put it back to something like its old purchasing power, and at least to make it once more a gold certificate and not a mere Governmental shin plaster, with its value at the mercy of political dishonesty and cowardice. It was only by bringing back the gold standard that we could hope to give to our money that degree of steadiness in value that had won our confidence before the war and had encouraged us to lend or invest it in the expectation that when it was repaid or we turned the investment into money again, the money would not cheat its owners by fetching only half as much as before, because the Government had debased it by making too much of it.

Steadiness was what we wanted in the buying

power of our money, modified by a very gradual return towards its pre-war value and • the restoration of the gold standard. This desire for a return towards pre-war value of money—or pre-war level of prices—was based on the view that the rise in prices had inflicted a great injustice on salary earners and wage earners and owners of fixed incomes who had not been able to expand their incomes as fast as it went, and that the rise had also put unearned and often unsought profits into the pockets of those who from the nature of their business, had to keep a stock of goods in hand. In other words it had, instead of laying the war sacrifice on the shoulders of all in accordance with their ability to bear it, as is roughly done by graduated direct taxation, made its burden unequal, and especially heavy for those least able to carry it. Since this injustice had been done, there was something to be said for the view that it should be partially amended by a reversing of the process by a fall in prices.

My own opinion was that a very gradual fall in prices was wanted for these reasons, but that anything like violent measures was the last thing that the occasion needed. It seemed to me that all that was needed was for the Government to forswear financial sack and live cleanly, paying off debt out of revenue; that artificial

efforts to deflate in a hurry might do as much harm as inflation; and that what was wanted was that the volume of currency and credit should be kept steady and that the gradual fall in prices, for which justice seemed to call, should be brought about by an increase in the volume of goods, which should very slowly restore the proportion between goods and money to something like that which had ruled before the war. To Professor Cassel, a Swedish economist who has won world-wide fame by his handling of after-war monetary problems, this method seemed to be a "particularly vain expectation." (*World's Monetary Problems*, page 63.) But he comes on our scene later.

In the meantime much more drastic measures seemed good to the powers that ruled us, and to an important body of lofty browed opinion among the economic theorists. It has already been recorded, at the end of the last chapter, that in November 1919 the Bank Rate was suddenly put up from 5 per cent. to 6 per cent., with a corresponding advance in the rate of discount at which purchases were invited of Treasury Bills, which were then put up for sale in weekly batches at a rate fixed by the Treasury. No special demands for credit from the Bank of England accounted for an increase in its price foı accommodation; no shyness on

the part of buyers of Treasury Bills made it necessary to tempt them with the bait of the lower price that is implied by the higher rate of discount. The export of gold having been forbidden, save under licence, fear of a foreign drain on the Bank of England's Reserve could not be alleged as the cause of this eccentric movement.

Bank Rate was thus recognized as a moral weapon to bring back to its senses a country given over to an unwholesome fever of speculation. Rapid deflation was the order of the day. Contraction of credit and currency was to be secured by rising rates for money and was to bring about a rapid fall in prices that seemed to great minds to be the logical sequel and correction of the previous rise. The ideal aimed at had been very forcibly expressed by one of our most distinguished economists, Professor Cannan, who had observed in the Introduction to his *Paper Pound of* 1797—1821, published in 1919, that "when the scales at last fall from the eyes of the people of Europe, groaning under the rise of prices, they will no longer cry to their Government, 'Hang the profiteers,' but 'Burn your paper money and go on burning it till it will buy as much gold as it used to do!'"

To minds mathematically inclined and

accustomed to weighing abstract problems in the perhaps rarefied atmosphere of an economist's armchair, this conclusion would naturally seem to be impregnable. Inflation and the increase of money by the printing press and the consequent rise in prices had produced chaos. Therefore the way to bring back order was to reverse the process and bring in deflation, the destruction of money by bonfire and a consequent fall in prices.

There were, it is true, some awkward details to be filled in before the scheme could become practical; for instance we had to be told how the Government was to be sure that it would not be obliged to issue new notes as fast as it burnt the old ones, because the consequent stringency in the Money Market was obliging holders of maturing Treasury Bills to insist on their being paid in legal tender. And those of us who had objected to inflation on the ground, among others, that it produced a disease, the cure of which might be as dangerous as its progress, might well ask our theoretical dictators to pause before applying logic too ruthlessly to real life.

The logic of the matter was very ably put by Professor Pigou of Cambridge, who in a letter to the *Times* printed in its issue of February 12, 1920, urged that the Bank Rate, which

was then 6 per cent., should be immediately raised to, and held at, 8 per cent , and that steps should be taken to make this rate effective in the market. He showed that we were suffering from the effects of speculation, credit expansion and high prices and that dear money was a check on all these evils. "That European nations, and England among the number, with the enormous losses they have sustained should have money at 5 per cent. and 6 per cent. while the United States and Japan with an incomparably smaller need for new capital should have very much higher rates is a financial paradox which it is impossible to sustain." And he maintained that "it is useless for the Government to squeeze out the part of the credit expansion for which public borrowing is responsible if money is kept so cheap that a reduction in credits created for Government is balanced by an increase in credits created for private persons " Against the suggestion that the contraction of credit, if necessary, could be much more cheaply brought about if the banks would agree to ration their customers, Professor Pigou urged that it was not possible to expect the banks, at the expense of their own profits to refuse credit to customers of good standing who offered sound security.

Theoretically it was a strong case admirably

put and practically the suggestion of a high Bank Rate was a great improvement on Professor Cannan's bonfire, to be continued till the Bradbury was as good as gold. Nevertheless, there was on the other hand a case to be made for the view that violent action through Bank Rate meant the application, at a time when violent measures were not at all wanted, of a remedy which had been, when gently used, a successful cure for overtrading in different days and under different circumstances. Any bill broker's clerk could have told the Professor that the sudden rise of 2 points in Bank Rate which he desired to see, during the last quarter of the financial year when the big tax payments always leave the market cold and shivery like a fleeced lamb, might very likely have produced panic. A rise of more than a point in Bank Rate was quite abnormal, and might easily have led the City to suppose that all kinds of horrors were upon it. He may have thought that panic was the only way to save us, and this was certainly the view at that time, of certain eminent theorists. But panic is easier to start than to stop.

Without panic Bank Rate seemed at that time most unlikely to produce the desired effect. In old days it had been effective in small doses because profits were finely

calculated, and all the conditions that entered into the consideration of those who were carrying on business were so well balanced that a marked change in any one of them was sufficient to divert the course of trade and traffic. Then, a rise in Bank Rate from 5 per cent. to 6 per cent. and then to 7 per cent. might really have been an important factor in the calculations of producers and merchants. But in 1919, and in the first quarter of 1920, the rise in prices was so quick and looked so unending, and the profits that it was pouring into the pockets of all who produced or handled goods were so fat, that a rise of a few points in Bank Rate and consequently in the price of the credit that they wanted, was almost an irrelevant detail in the calculations of those who were conducting enterprise.

They had to have money, or thought so, whatever it might cost them, because " the pace was too good to inquire " about a minor item in the prospective balance sheet like the cost of money, when whatever they bought with it soared up fast enough to cover its cost and leave plenty of margin, and when orders were so plentiful at any price that they chose to name that many of them found it necessary to invent ingenious devices for avoiding customers whose needs they could not satisfy.

Later on when the wind blew on the other cheek and prices were falling like a stone, and buyers were not in battalions or even in single spies, but had vanished from the face of the earth, the price of money was equally irrelevant for a different reason. Producers and merchants had to have it then, because they could not sell their goods and in all countries the buyers who had bought so gaily were repudiating contracts and refusing to take delivery, and an insatiable demand had given way to glutted stagnation. And so those who had goods in hand had to have money whatever it cost, because they simply could not sell them and were forced to carry them on credit. And so Bank Rate and the Treasury Minute, which was supposed to set a limit on the note issue, had no visible effect according to the testimony of available figures, in contracting credit, because credit could not be contracted until the stock of unsaleable goods was gradually worked off.

Professor Pigou's grievance against the banks they were expanding credits for private persons and so defeating the effect of the Government's action in squeezing out part of the credit expansion due to Government borrowing, was one of which the unfortunate bankers, who had so often before been told

that they must cultivate a spirited and venturesome policy during the transition period from war to peace, now heard a good deal. This action of theirs really had a good deal to be said for it. Credit expansion created for the Government's use is, except as a purely temporary measure, bad and cowardly finance, because the Government is not engaged in production and so fresh money made for it cannot, from the nature of the borrower, lead to the making of fresh goods to restore the balance between goods and money, and so is certain to swindle all owners of the money already existing. But when credit made for Government is paid off and the banks' balance sheets are to that extent cleaned and lightened on both sides, it is not necessarily a bad thing for new credits to be given by the banks to private borrowers because there is a good chance that most of the new money will be used in enterprise and production, and this is especially so at a time of abounding trade prosperity when producers are making big profits. By this process deflation of credit is certainly defeated, but on the other hand trade is kept active and the fall in prices which was the object of the deflation is produced in a much more satisfactory manner by an increase in goods accompanied by no increase in money, since the

new money merely replaces the Government money that had been cancelled.

Bankers, however, were severely lectured at the time by politicians and officials who thought they knew best about the needs of business, and *contrasted*, as *did* Professor Pigou, the highly meritorious action of the Government in reducing, as it began to do after the end of 1919, the credits that had been created for it during and after the war, with the nefarious policy of bankers who made the Government's action "useless" by giving fresh credit to customers. One day a banker turned on one of these official lecturers and showed that not only were the bankers justified in their policy but if they had not carried it out the Government could not have effected the much boasted contraction. For the margin of revenue over expenditure which enabled the Government to redeem debt and cancel credits was not produced by genuine taxation, but, as shown above. by the sale of assets; and the Government could not have sold these assets if the bankers had not lent their customers the wherewithal to pay for them. So that all these scoldings of the bankers were based on ignorance of what was really happening.

As to Professor Pigou's demonstration that it was hardly possible to produce a contraction

of credit by means of *rationing*, since bankers could not refuse the demands of good customers for advances, especially when it was against their own interests to do so, the fact nevertheless remains that it was just this process which first checked and finally reversed the expansion of credit. There was no definite system of rationing but the banks did succeed in bringing home to their customers the need for moderating their demands for credit and for contracting the accommodation that they had received by reducing advances, as soon as sales of goods began to be possible at a lower level of prices. It was this action by the banks in persuading their customers that unlimited expansion of credit had to stop, that stopped it far more than the rise of a couple of points in Bank Rate. Banking figures went on expanding long after the rise in Bank Rate and only contracted appreciably when Bank Rate was being reduced again. It was not dear money that put the brake on, but recognition by bankers, and their communication of this conviction to their customers, that a brake was needed: though it is quite possible that the rise in Bank Rate helped to produce a state of mind which enabled the banks and their customers to reach and act on these conclusions.

All this had to be recalled firstly because

these things are very relevant in view of the now fashionable doctrine of economic salvation through Bank Rate and also because the Bank of England and the Government are often unjustly accused of having produced by means of their dear money policy the depression and unemployment from which we are still suffering. The only certain effect of their dear money policy was that the poor old taxpayer had to pay a few millions more than he need have done, because the authorities saw fit, in order to cure the country of a naughty fit of gambling, to issue Treasury Bills on terms which were more expensive than they need have been. What really stopped the feverish activity of trade and the mad rise in prices—which was partly due to the fact that in order to secure delivery people got into a habit of bidding for two or three times as much stuff as they wanted—was the discovery by the consuming public that it could not stand the pace, and its determination to stop buying until prices had stopped rising.

This "consumers' strike" began in America and was imitated, with less definite organization but with equal determination, in this country; but it was the Far East that first reminded the rest of the world that rising prices were not a necessary part of the scheme of the universe.

The Chinese saw fit, on political grounds, to boycott Japanese goods, and there was a quick tumble in the Japanese silk market which reacted on America and brought hope to the hearts of millions of consumers, who for years had been fleeced by the bad finance which had debased the currencies of the world, and now at last saw that lower prices were a possibility. But the trade relations of China and Japan certainly were not influenced by the Bank Rate policy of the Bank of England or the United States Federal Reserve Board.

Very interesting evidence on this point was given by the Hon. Benjamin Strong, Governor of the Federal Reserve Board of New York, before a United States Congress inquiry, held in August 1921, apparently because it was claimed that the policy of the Federal Reserve Board had been injurious to American agriculture. Governor Strong told the inquiring Commission how the speculative tendency had, in 1919, worked up into "a veritable orgy of extravagance, waste and speculation; there was in fact competition to buy anything at almost any price. This culminated in the early summer of 1920. Now the first rumblings of a coming break appeared in March and April of 1920, in Japan, where I happened to be travelling. I was there at the height of their

period of liquidation and distress and had opportunity to observe on the ground exactly what was transpiring. It has frequently been said that the percussion cap which started distress in Japan was the sudden cessation of the demand for silk in the United States. I do not think that is quite accurate. The Japanese exporters had suffered misfortune through various causes and a very wide and effective propaganda in China, boycotting Japanese goods. And I was told of vessels that were held up in Chinese ports, not being able to unload their goods; and that was also coincident with the cessation of the buying of silk in this country. This reaction extended from Japan into China, the Dutch Indies, India and Egypt, and the same conditions prevailed generally throughout the East."

This evidence given by the Governor of the New York Federal Reserve Board is, in fact, by far the most interesting and effective defence of the monetary policy which was followed at this critical period, both by the American and British financial authorities. It was usually asserted in the City that New York led the way and that London supported and followed its policy, but I have always inclined to the belief that New York and London acted in

concert throughout. However this may be, it is most fortunate that the American inquiry produced this evidence of Governor Strong's which will, I think, some day take its place with our Bullion Report of 1810 as an historical document of quite exceptional interest. On our side of the water, we were satisfied with the majestic reticence which at the half-yearly meetings of the Bank of England provides

That sort of farthing candelight which glimmers
Where reeking London's smoky cauldron simmers,

and Parliamentary discussion of the Treasury Minute of December 15, 1919, was confined to a few back-bench bleatings. Fortunately, our American cousins "wanted to know," and Governor Strong told them all about it. Everyone interested in these matters should read his evidence in full in the "Hearing before the Joint Commission of Agricultural Inquiry, Seventy-Seventh Congress, First Session, Under Senate Concurrent Resolution 4."

Here he must be all too briefly summarized. He said that during the period of speculation and rising prices the Federal Reserve Bank's policy was to endeavour by every means at its command to arrest this development, but the atmosphere of those days created difficulties. "The people had economized for two-and-a-half

years and they wanted now to enjoy themselves." Moreover in finance the war was far from over "because we had still ahead of us a loan which at that time we felt would be about $6,000,000,000—the Victory Loan." Governor Strong went on to describe how in the summer of 1920 when the public stopped buying it was just like closing the outlet of an elastic pipe, with the water being constantly forced in at the other end. "The pipe will certainly expand," and it did. Consumption stopped at the point of retail distribution but production at the point of origin still continued and "during this period goods piled up all along the line." Raw materials immediately fell and "that is the characteristic of periods of depression that the first to suffer collapse in prices is the producer of raw materials." During this period of decline and of "backing up of goods" the loans of the Federal Reserve Bank did not decline. "The curve of prices dropped quite markedly, but the volume of bank loans continued to rise for some time before it began to go down, indicating that the first result of this curtailment of consumption was a pressure upon the banking system for credit to carry these goods and a decline of the curve representing bank loans could only be expected when consumption began and debts

were paid." And this continued rise in bank loans was actually encouraged by the Federal Reserve Board. It had to be so because if the banks had not given the necessary helping hand to industry and commerce there must have been widespread disaster. Governor Strong states frankly that during this period of declining prices "our policy was designed to encourage the extension of needed credits."

Thus out of the mouth of this witness whose knowledge of the whole course of events is from the nature of his office unrivalled, we learn that the tumble in prices began in the Far East and spread to the rest of the world, which does not look as if advances in money rates in London and New York had much to do with it; and further, that when the tumble was in progress the New York Federal Reserve Bank was busily encouraging the extension of credits. And this shows very clearly that the fall in prices was not caused by any contraction of credit because credit was officially encouraged to expand, certainly in New York, and probably in London also.

We thus have very valuable evidence for the view that the rise in money rates here and in New York at the end of 1919 and the beginning of 1920 did not cause the fall in prices and the check to speculation, or if it did, it did so through

psychological suggestion and not by any means of credit contraction, because credit contraction did not happen. And this evidence is all the more important because it is given by a banker who nevertheless believes that the policy of raising rates was right. He admits that "in many directions we were like prophets crying in the wilderness. We could not stop that rage of speculation by any means at our command, at least so it appeared at that time." Nevertheless, "I believed then, and I believe now, that the basis, the fundamental basis of restraint upon speculation rests upon the cost of credit, and that the policy of raising our rates was necessary and justified, and without the adoption of that policy this expansion which took place would have gone to unparalleled levels."

But surely cost of credit can only restrain speculation by making speculators think that if they have to pay so much for credit the game is not worth the candle and consequently closing their commitments and reducing credit by paying off their loans. But this did not happen either here or in America. As long as prices rose, speculators did not want to close their commitments. When prices fell, they could not close them. And we must always remember when we take measures for checking speculators by means of money rates that we run the risk

of checking, at least as effectively, the real producer. If we take the heart out of him, it means a lessening in the effort which increases the real wealth of the world, and he with the strict attention to business details which means so much for his success, seems much more likely to be put off his stroke by an item like the cost of money, than the free and easy speculator who is used to making big guesses on broad lines, and then backing his opinion in glorious self-confidence.

Interesting as is Governor Strong's evidence on the course of events and the purposes aimed at by the Federal Reserve Board, he does not quite convince one that in the exceptional circumstances that prevailed at the end of 1919 and the beginning of 1920, the rise in money rates that was actually brought about was a serious factor in the calculations of business men, or even that at any time " the fundamental basis of restraint upon speculation rests upon the cost of credit." Surely if a man thinks that by buying a security or a commodity or a currency he gets a good chance of being able to sell it in a few months at double its present value, he will be quite ready to pay 20 per cent. or even 50 per cent. for any money that he wants to finance his gamble; and such a movement as a rise in Bank Rate from 5 per cent.

to 6 per cent. and then from 6 per cent. to 7 per. cent. would have been quite ineffective, had not other events caused speculators suddenly to remember that rising prices sometimes stop.

This point of view was very ably put by another eminent American authority, Mr. Albert Strauss, an ex-Member of the Federal Reserve Board. Speaking in May 1922 he said "Booms and depressions are caused by hope of higher and fear of lower prices, whether of commodities or of securities. The hope of higher prices leads to demands for funds for the purpose of purchasing in anticipation of a rise; the fear of lower prices leads to repayments of loans with the proceeds of sale in anticipation of a fall of prices. No rate; however low, will tempt borrowing for the purpose of purchasing a commodity whose price is believed too high—and broadly speaking, no rate, however high will, by reason of its being high, restrain borrowing intended for the purchase of commodities which are believed certain to rise. A high interest rate will often deter borrowers because it is taken as a warning that commodity prices are regarded as too high or that money may become unobtainable at any price. It will serve as a concrete expression of opinion by those best

qualified to judge as to the reasonableness of the general level of prices."

Quite so, and this being so, it should surely have been possible to warn speculators and the public and all other parties concerned that prices are regarded as too high, by some less expensive method than the one which involved selling cheap Treasury Bills at the expense of the taxpayer and making the real producer and trader pay more for money in order to convey a roundabout warning to the speculator which he blandly ignored until a Chinese boycott of Japanese goods upset the silk market and tumbled over the whole house of cards. In old days when Bank Rate went up it meant that a gold drain was occurring or expected and a gold drain meant that there was less money in the country, and that borrowers whatever price they liked to pay, would have to have less. And so it was a very real warning. In 1919 and 1920 there was no question of a gold drain, and rises in Bank Rate, whatever other effects they may have had, certainly did not cause contraction of credit.

Just consider these few facts. Bank Rate was 5 per cent. when the war ended in November 1918. It rose to 6 per cent. in November 1919, 7 per cent. in April 1920 and stayed there until April 1921, then declining

by easy stages to 3 per cent., which it reached in July 1922. Prices of commodities reached their highest point in March 1920 and then fell with unparalleled quickness, but gradually slackening pace, until September 1922. The decline, during the last eighteen months of its course, was thus accompanied by a fall in Bank Rate from 7 per cent. to 3 per cent. Bank deposits in the United Kingdom—the nearest approach that we have to a test of the extent of credit—stood at £1,032,000,000 at the end of 1913, according to the *Economist's* tables, and were £1,988,000,000 in 1918, £2,356,000,000 in 1919, and continued to expand until the end of 1921 when they stood at £2,527,000,000 utterly refusing to obey the behest of Bank Rate and contract when it went up. Contraction happened in 1922, when they came down to £2,362,000,000. And this was the year when they were being urged to expand by Bank Rate, which came down from 5 per cent. to 3 per cent. Surely these facts and figures looked at together make it most difficult to believe that prices and credit, industry and enterprise are merely "a pipe for Bank Rate's finger to sound what stop she please."

Nevertheless, in trying to show that the United States Federal Reserve Board and the Bank of England and the British Treasury

had, in raising rates, done something which was largely ineffective, very costly and rather futile, we are much kinder to them than the critics who think that Bank Rate is in fact all powerful and that it was the main cause of the after-war gamble by not having been put up, and of the subsequent depression by not having been put down again. In February 1922 a paper was read before the Royal Statistical Society by Mr. R. G. Hawtrey, distinguished even among the brilliant band of our Treasury officials by reason of his eminent abilities which he has applied to the elucidation of monetary problems in works which are classics as soon as they are published. His paper was headed "The Federal Reserve System of the United States" and has now been republished in a volume entitled *Monetary Reconstruction.* It was an attack, suave and courteous, but almost impassioned in its earnestness, on the handling of the monetary situation by the Federal Reserve system. He charges it with having tried to cope, in 1919, with a menacing situation by tentative and hesitating steps, and though he thinks that the raising of its rediscount rate to 7 per cent. in June 1920 was at last successful and turned the tide, yet "the ebb had to be proportioned to the flow. In so far as the expansion had got out of hand, the

subsequent contraction had to be more severe." Later on he says that "the whole world has been plunged into the most appalling distress for nearly two years by the strain of raising the commodity value of the dollar 80 per cent. . . . How did such a mistake ever come to be made? The explanation is, I think, simply that the working of the 'vicious circle' of deflation was not understood. It was not realized that a deterrent discount rate, once it had taken effect, can safely be reduced."

This is surely a most interesting example of the success with which a really philosophical mind can detach itself from the facts of life, and can isolate certain items that interest it and subject them as if in an imaginary test tube to experiments that have no connexion with practical existence. Anyone reading Mr. Hawtrey's paper might suppose that the war had only inflicted loss on humanity by disarranging the currency system and that all the miseries of the after-war period were due, not to bad temper, a bad peace and the failure of European politicians to let their countries get back to work, but to the slow and tentative steps with which the United States Federal Reserve Board raised its rediscount rate and its failure to see that the rate might come down again much sooner than it did. Surely Mr.

Strauss was much nearer the truth when he said " no rate, however low, will tempt borrowing for the purpose of purchasing a commodity whose price is believed too high ": and the appalling distress in which the world has lately been plunged was much more due to the bungling of politicians in this hemisphere than to the price of money in the other. If the other countries of the world had been in a normal condition with their industry and finance working smoothly and in good health, no action or inaction with regard to its rate of rediscount on the part of the United States Federal Reserve Board could have plunged them into " the most appalling distress " for nearly two years.

CHAPTER VI

CRITICS AND SUGGESTIONS

NOT only did the effects of the war on our currency and banking system stir to fresh efforts those who had always wanted to reform it, they also produced a host of new critics with new suggestions for its improvement. They may be divided roughly into three classes: those who find the way to economic salvation in unlimited issue of paper money which they generally call by some other name; those whose doctrine and intention are vague or incomprehensible; and those who want, either with or without a return to the gold standard, to set up machinery by which the level of prices is to be kept steady through official, and sometimes international, regulation of the volume of credit.

In considering the doctrines put forward by these several classes we are faced with the difficulty that it is not always easy and it is sometimes quite impossible for ordinary folk to understand what currency reformers really want to do, and it is also interesting to note

that sometimes they make a definite movement to a new position

This was the case with the veteran champion of what he believes to be banking reform, Mr Arthur Kitson This versatile critic has several embodiments In one, though he vehemently denies that he is in favour of unlimited credit, he uses expressions that seem inevitably to lead to that ideal In another—as shown in his *Fraudulent Standard*, apparently written in 1917—he advocates a system of so regulating the supply of money that "it preserves the uniformity of an invariable index number" (page 132), and so seems to join hands with the stabilizers In another he declares himself the champion and interpreter of the new economic apostle, Major Douglas, whose scheme he apparently swallows whole In the last year of the war he had published in the *Times Trade Supplement* a series of articles on banking and currency problems and I was highly honoured by being asked to reply to them They, together with my replies and other works of his, have now been published in a little paper book called *Money Problems*—(Dolby Brothers, High Street, Stamford) In the article published in the June *Supplement*, Mr Kitson told us that "if the British public would only grasp the

fundamental truths of Economic Science they might learn that a future of boundless wealth and prosperity is theirs, provided they have the will and determination to secure what is well within the bounds of possibilities. . . . We must first decide to break with the past by getting rid of our bankrupt political and economic ideals and methods, our conservatism, our ignorance and superstition."

So far most of us will follow him. "We must rid ourselves," he continued, "of those foolish laws—the relics of the ignorance and prejudices of our forefathers—such as the Bank Charter Act and other parliamentary restrictions." He went on to show that wealth is the product of two prime factors—man and nature—generally termed labour and land, and asked how it is, "with an unlimited or practically unlimited supply of these two factors," that wealth is, or hitherto has been, so comparatively scarce? And he answered the question by saying that "a study of the currency and bank methods of all industrial nations for the past century will convince every unprejudiced person that the scarcity of wealth and the limited amount of production has been due primarily to the legally restricted supply of money" (page 32).

It was indeed a most hopeful theory.

Everything else needed for wealth we were alleged to have in practically unlimited supply; all that we lacked was money, and war had shown how easily money could be multiplied. We only had to make Mr. Kitson our Currency Controller, or Currency Creator—for with his theory he would surely have scoffed at the notion of control—and give him a free hand to print, and boundless wealth was within our reach.

And yet one or two points in his argument are not quite clear. Is it really true that we have a practically unlimited supply of "man" and of "nature"? There is indeed quite a large number of men in this country, but how many of us are really well equipped for increasing its wealth, trained to do our jobs as they ought to be done and eager to work as hard as it would be necessary for us to work before boundless wealth began to look like being our portion? Is one in a hundred an optimistic estimate? And as to "nature," there is plenty of it lying about in the world, but much of it is not ploughed or tilled, means of communication are not yet all that they should be, and some considerable additions to plant and machinery seem to be required before we can be sure that lack of money is the only bar to an endless flow of milk and honey.

Mr. Kitson, however, has no such doubts. "Since," he says, "sales were limited by the amount of money or credit offered, it followed that production was necessarily limited by the quantity of money and credit available for commercial purposes." It did not seem to occur to him that a larger volume of production might easily have been carried on with the same amount of money by a readjustment of the price level. But after all, what has happened since then has quite sufficiently answered Mr. Kitson. If unlimited money was all that was needed to secure abounding prosperity, it ought now to be evident in Russia, whose inhabitants are in fact living in a state of economic chaos that appals all who contemplate it. Mr. Kitson would doubtless reply that circumstances in Russia were exceptional. In his view "the average business man is growing tired of having to go hat in hand to solicit 'favours'" (referring to getting accommodation from banks) "which he claims should be given to him as a legal right." This may be so, but most business men of my acquaintance see very clearly that if everybody had a legal right to as much credit from the banks as he thought fit to demand the amount of credit created would in times of optimistic exhilaration so rapidly outstrip the supply of

goods, that a wild orgy of competitive buying would almost certainly end in disaster; and that the ultimate end of such a policy is complete worthlessness of money and a return through chaos to the barbarisms of barter.

In 1921, however, Mr. Kitson was dining with some friends, including well-known financiers and merchants. The conversation soon turned on the industrial paralysis that then prevailed which was attributed by various speakers to various causes. As he describes the scene in a preface to a subsequently published work, entitled *Unemployment*, he seems to have dealt faithfully with his companions. " The writer's turn came last and he expressed himself as being in entire disagreement with every member. Not one of the reasons so far urged for our industrial woes would stand even the most superficial investigation, and consequently the remedies suggested were not only worthless but foolish." He went on to attribute the depression to a deflation policy announced about twelve months before by Mr. Chamberlain, and maintained that industrial and social conditions would grow worse until this policy of credit contraction was reversed. He was finally challenged by his opponents to furnish a remedy for unemployment and industrial depression. The result

was a new series of articles, and a new book, as already mentioned, in which Mr. Kitson, after recommending various minor means of credit increase, such as paying pensions and unemployment allowances, not by rates and taxes but by the issue of fresh currency (page 38), and the conversion of the floating debt (which in the early part of 1921 was not far off £1,500,000,000) into legal tender currency (page 43), finally decided that the system suggested by Major Douglas in his remarkable books entitled *Economic Democracy* and *Credit Power and Democracy*, would in his judgment " effectively solve the whole problem of unemployment, trade depression, and all their attendant evils, and if adopted universally remove the causes which have been so fruitful in provoking wars and which if not speedily removed must soon give rise to fresh and more desolating wars than any yet waged."

Everyone interested in currency matters had already heard much of Major Douglas and his scheme which was adopted and ventilated at length by the *New Age*, at that time the well written and interesting organ of the Guild Socialists, led by Mr. Orage. I had made an honest and determined effort to read one of Major Douglas's books, and having failed to understand how the scheme could work, had

asked the Major to lunch and spent some very pleasant and interesting hours with him, at the end of which there had been no deflation in my bewilderment. I knew that this was probably my fault, and I was really cheered when Mr. Kitson, having first stated that the problem of unemployment "when properly understood is so simple that the average schoolboy ought to be able to furnish a satisfactory answer," went on to the Douglas scheme as a solution. For it seemed safe to suppose that if the matter was really as simple as it seemed to Mr. Kitson, he would be able to translate the Douglas scheme into something that an ordinary intelligence could grasp. And as he went along in his leisurely discursive manner he certainly let fall by the way some most encouraging gems of assertion, as for instance (on page 33) when he said that "even to-day the labour of less than 10 per cent. of the population will readily suffice to maintain the entire inhabitants of this country in a high state of comfort." But it is when he begins to summarize Major Douglas that the prospect really begins to dazzle (page 55). "The potential wealth of this country is far beyond the dreams of avarice, and under a system of co-operation and goodwill everyone might by contributing a trifling amount of labour, receive a share of all the

good things of life sufficient for his well-being, contentment and happiness. Every member might thus receive an income from the State instead of being taxed. By gradually replacing the wage system with a system of dividends, by giving a share to each and every member engaged in an industry in that particular undertaking, the evils now resulting from unemployment would disappear."

It was a mouth-watering prospect. Instead of paying taxes I should dun the Inland Revenue Department for emoluments due to me, and the wage earners would beat their tools, not into ploughshares but the more comfortable shares that have dividends attached. And then came the scheme. What may be described as Major Douglas's major premiss is a belief based on "a system of costings" that "the purchasing power distributed to the public by the industrial system in all countries could not possibly enable them to purchase more than a small proportion of the goods made, even if these were offered at the minimum price of bare costs." If this were so the inevitable results would appear to be a chronic and ever growing glut of unsold goods and the whole of industry in the hands of receivers; and yet somehow industry has managed, in spite of a system which is "inherently suicidal," to sell its

output and maintain through some centuries an appearance of chequered but rather ample prosperity However, "to meet the discrepancy," says Mr Kitson (page 56), "between prices and purchasing power distributed, Major Douglas proposes that producers shall sell their products below cost at a price which shall bear the same ratio to cost as the total national consumption of all commodities does to the total national production of credit The difference between such prices and cost of production is to be made good by a draft from the Treasury on the national credit account Under this scheme, price, instead of being a function of money, becomes a function of production Hence any over issue of money cannot affect prices and the evils resulting from inflation under our present system are therefore eliminated"

Well, all this must evidently be quite clear and simple to Mr Kitson, but he surely might have told us what Major Douglas really meant when he said that products were to be sold below cost price at a price bearing the same ratio to cost as the total national consumption of commodities bears to the total national production of credit For these remarks are not really simple at all except to very clever people, and what we want to know is how the total

national consumption of commodities at any given moment is to be estimated, unless almost half the population is kept busy weighing, measuring and checking the consumption of themselves and the other half; and if so, what becomes of the theory that the labour of less than 10 per cent. will suffice to keep us all in a high state of comfort? And what is the total national production of credit, and who is to measure it and how?

As to how the system was to work by which goods were all to be sold below cost price, and the difference between prices realized and cost of production was to be made good by a draft on the national credit account, was another matter that cried aloud to be explained. Apparently, to take a concrete example, a bootmaker who made boots out of materials that cost him fifteen shillings a pair and with the help of labour that cost him five shillings a pair, would have to sell them for something less than a pound a pair and could get back the difference from the Treasury in the shape of a draft on the national credit account, whatever that may mean. He has thus made nothing out of the transaction, but has received with the assistance of the Treasury as much as he paid out. Is he expected to go on carrying on the business of a bootmaker for nothing to the extent of the

demands upon him and his neighbours, and what is he to live on in the meantime if he continually receives only as much as he pays out? And if everybody is doing the same thing what has become of that glorious system with which we were so lately dazzled, by which everybody was to be a shareholder living on a comfortable stipend from the State? Nor is confusion on these points lessened by an endeavour to understand the "exemplary scheme" drawn up for special application to the mining industry. In fact, the Douglas scheme as expounded by Mr. Kitson was at least as incomprehensible as when drunk from the original fountain.

Fortunately it was proved that inability to appreciate the Douglas scheme was not necessarily the result of my middle-aged prejudice; for it was weighed in the balance and found wanting by the Labour Party, which in a pamphlet entitled "Labour and Social Credit" subjected it to most effective analysis through a Committee whose distinguished members included such well-known economists as Sidney Webb, G. D. H. Cole, Hugh Dalton, J. A. Hobson, Sir Leo Chiozza Money, R. H. Tawney and Arthur Greenwood. It expressed inability to understand how the aggregate surplus of production over

consumption of the whole nation can be computed. "It is impossible to add together yards of cotton, tons of coal, gallons of milk, and additional cottages, schools and factories otherwise than in terms of money; and the money valuation is dependent on the price to be set upon each of the different commodities." This is a very palpable hit for it was part of the Douglas scheme, as noted above, that the cost of each article was to depend on the relation of total consumption to total production.

The Major's amazing proposal to let each manufacturer make good the loss caused by selling goods below cost of production, by a draft from the Treasury on the national credit, seems to the Labour Party critics to be "equivalent to a continuous flooding of the nation with paper money which would rapidly sink in value." This would inevitably take the form of a rise in prices, which no authoritative fixing could prevent. "Major Douglas," they continue, "denies that this issue of paper would inflate prices, on the ground that it is issued against 'real credit' or a 'potential productivity.' But first let it be noted that no provision appears to be made for cancelling any of these notes, which would therefore increase indefinitely. Secondly, the people who receive the notes will presumably wish to spend them,

and in the last resort, to spend them on buying goods. In the result, either prices must go up in face of the abundant purchasing power and limited supply of consumable goods, or if all prices could be rigidly controlled by law, the money demand would far outrun available supplies. Short of a bureaucratic rationing system, some parts of the country and some consumers would find themselves with no goods at all. In fact, we should be back in the worst experiences of the war, in soaring prices, inadequate supplies, queues and the rest of it—only very much more so."

Such are the terms, or some of them, in which the Douglas scheme is dismissed by the Labour Party. Those who think that the matter is worth study will find this critical examination useful and, though distinctly severe, quite fair on the whole. In one respect, however, I think that Mr. Webb and his colleagues scored what they thought was a bull's-eye, but was really a miss, because they had not appreciated the true beauty of Major Douglas's intentions. It was in discussing his proposal that a new and special banking company should be set up for each industry, and that this banking company should be given the right by law to furnish, in return for shares, a steady increasing proportion of the additional capital required from time to

time by the existing capitalist employers in the industry.

Everyone engaged in the industry was to be, as such, a shareholder in the bank. All wages and salaries were to be paid by the directors of the industry into the bank, and the employees would draw cheques on the bank to meet their living expenses. But the bank having the right to provide a proportion of the new capital required, would in the case of the Miners' Bank—the shareholders in which are all the persons employed in the mining industry—"find itself owning a steadily increasing number of shares in the steadily increasing total share capital of the colliery companies without the miners having had to put up any money at all" "This sounds delightful," say Messrs. Webb and company. "Unfortunately, it overlooks the elementary need for the Miners' Bank to have the capital before it can supply it to the colliery companies in return for their new issue of shares."

But they surely do Major Douglas a rather grave injustice. To such a monetary magician there would be no difficulty about producing the capital simply by another draft from the Treasury on the national credit account, or, perhaps still more simply, by giving all the new banks the right of unlimited note issue and

making their note issues legal tender. By this system every industry can have as much capital as it likes without any regard for the needs of others, all of which would be supplied by their own tame banks, and all workers in all the industries, being shareholders in all the banks, would thus become capitalists without having to go through the effort of saving. Major Douglas has perhaps rather spoilt this part of his scheme by saying the bank as such shall pay no dividend. This seems rather mean and cheeseparing, and surely everybody would be much happier if they all had 10 per cent. dividends paid into their accounts. As to what would happen to prices with all the banks ladling out capital as fast as their industries asked for it—but we have Mr. Kitson's assurance that price under the Douglas scheme becomes "a function of production" and "hence any over issue of money cannot affect prices."

Major Douglas's Labour Party critics having dealt faithfully, as shown, with the Major, proceed to lay down that the "social control of credit and the banking system" may best be achieved by the nationalization of the joint stock banking system and the energetic development throughout the country of municipal banks. Well, the cobbler will talk leather

our economic tangle. And then came this pamphlet with one of our greatest scientific names upon it, and I looked for light at last. Professor Soddy states his intention to try to bring the existing knowledge of the physical sciences to bear upon the question "How do men live?" He says that the modern economist, for whom he evidently has a most hearty contempt, seems to have forgotten that there is such a question.

To illustrate it he asks what makes a railway train go. He admits that in one sense or another the achievement may be claimed by the engine driver, the guard, the signalman, the manager, the capital, the shareholder, the scientific poineers who discovered the nature of fire, the investor who harnessed it, labour which built the railway and the train, but "the fact remains that all of them by their united efforts could not drive the train." This seems to be a sort of fact that an ordinary mind might almost have hit upon without the help of a great scientist, and when Professor Soddy goes on to say that "the real engine driver is the coal" he seems to imply, by contrast, that the coal, by its sole, unaided effort could have driven the train without the assistance of all the other factors. Whereas if the capitalists and the engineers and the navvies had not financed and

planned and built the line, even the coal could hardly have sent the train very far on its journey.

Professor Soddy's main quarrel with what he calls "orthodox economics" is that "it confuses the substance and the shadow, it mistakes debt for wealth, and is guilty of the same mistake as the old lady, who, when remonstrated with for over-drawing her account, promptly sent her banker a cheque for the amount." Many economists are certainly in the habit of explaining themselves carelessly enough to have given this impression to Professor Soddy; but he surely, in bringing this very serious charge against a body of earnest and industrious workers of misunderstanding the very root of their problem, might have cited an example or two, or at least given us a few references to look up, in proof of this sweeping assertion. As it is we are left in doubt as to whom the Professor means as exponents of orthodox economics.

Is this really the "scientific" method of dealing with a problem—just to make an assertion, unsupported by evidence of any kind except the Papal *ipse dixit* of an eminent Professor? It seems to be so, for he further observes "the fact is that the economist, ignorant of the scientific laws of life, has not

arrived at any conception of wealth, apart from the elaborate code and enactments of legal conventions which give to the individual in actual non-possession of wealth the right to acquire it, whereas I, from the application of the laws of energy to the problems of how men live, have arrived at such a conception."

We may leave the economists to deal with the Professor's charges if they think it worth while. To us ordinary folk it would be useful if he would be clearer as to what this conception really is. He has already confused and puzzled us by his example of the train and the coal, and on the subject of wealth he is even more bewildering. For he tells us that "the wealth of a community can only be increased by production and discovery, not by acquisition and exchange. In commerce and exchange for every plus there is a precisely equal minus." Has he really tumbled into that schoolboy's pitfall which makes folk believe that every merchant or dealer who makes a profit inflicts a loss on somebody else? It seems so, but surely Mark Twain was nearer the truth when he tells us how Tom Sawyer exchanged a tooth, lately pulled out of his own head, for a tick possessed by Huckleberry Finn, and the two boys then parted "each feeling wealthier than before." They were wealthier because each had got

something that he wanted more than the article disposed of. When Professor Soddy lectures and writes and otherwise distributes the learning for which he is so eminent in his real field, he surely exchanges that learning for goods which he buys with the fees that he receives and so confers a double advantage by handing over knowledge to those who need it and taking goods from those who have made them and passed them on through the merchants for sale.

When we come to the narrower problem of money, the Professor is acute and illuminating. He sees that the quantity of money as compared with that of goods is the most important item in its value, " It ought to be in precisely the same relation to the revenue of wealth as a food ticket becomes to food supply, or a theatre ticket to a theatrical performance" (He surely means to the seats in the theatre). Again, the "currency must be regulated *pari passu* with the changing revenue, issued as the latter expands and destroyed as the latter contracts. Since it would neither be given away in the first nor taken away in the second event, but used to buy back old, or taken in exchange for new State Loans, the community as a whole would share the prosperity of good times as well as the stringency of bad ones, instead of only

the latter as under the existing system" (pages 16, 17).

This proposal for expanding and contracting the currency by debt redemption and debt issue might evidently be difficult and expensive to work and recent experience has shown that it is possible for an expansion of currency to coincide with a heavy fall in prices. But all this question of the possibility of keeping prices steady by expanding currency and credit like a concertina will have to be discussed more fully later on. We should have been glad of more light on it from Professor Soddy, for it is not really quite as simple as he seems to think. He says that he "will be asked by those who are unaware of the proposals made by Gesell on the Continent and by Kitson in this country, how is it possible to fix the purchasing power of money? The answer is simple enough: By fixing it, that is, by printing more as average prices, determined by Index Numbers, tend to fall and by withdrawing it from circulation as they tend to rise." This may be a "simple enough" answer, but as will be seen practice might be rather more difficult than precept. And one feels all the more confidence in doubting whether the Professor is really well-informed on the subject about which he lays down the law with such magnificent conviction, when one

finds that when he does condescend to give a few facts they look remarkably like figments. "It is," he says (pages 18, 19), "on record that a group of American financiers on one occasion, having sold British and bought American securities in advance, removed £11,000,000 from the Bank of England and put it into circulation in America, with the result that the prices of the securities they had sold fell greatly in value and those they had bought rose correspondingly." Surely when a distinguished Professor is lecturing to groups of young students he should not make statements of this kind without some attempt at corroborative evidence. Where is this amazing fairy tale "on record"? The Professor admits that this instance is an extreme one, but goes on to say that "when one inquires further as to who is in charge of the calibration arrangements that fix the purchasing power of money much that has hitherto seemed inexplicable about our time becomes clear. These powers are wielded, by private banks, like the Bank of England, in the steadfast interests not of the community but of the creditors of the community. Whereas no changes of revenue, so long as the currency remains constant, affect the relative proportion of the whole revenue secured by creditors, any increase of currency diminishes

their relative share, and hence is known as inflation, while any decrease increases their relative share and hence is called sound finance." This passage appears to mean that in the interest of creditors the Bank of England continually works to reduce the amount of currency in the country. If so, its effort has been singularly futile, seeing that at the end of 1869 (as shown in Bagehot's *Lombard Street*) its own note issue was £33,250,000 and at the end of 1913 it had grown to £52,250,000, to say nothing of its expansion to £144,000,000 at the end of 1922. Surely the Professor might have asked some office boy in the City a few elementary facts about what happens there, before making assertions that are so amazingly incorrect. Can this really be the system on which our greatest scientific minds conduct investigations?

A scheme with some theoretical attractions was worked out by Mr. Henry Lowenfeld in a book called *Back to Prosperity* published in 1923 (Effingham Wilson). He proposes that "a Corporation should be formed, composed exclusively of bankers, representatives of the entire banking interests of the country. The Government should authorize this Corporation to issue the 'money' of the country and should make that 'money' the exclusive legal

tender money. The sole business of this Corporation should consist in discounting bills *with its own notes and coins*. In this way, the new money will first of all pass into the hands of banks, and through them be put into circulation. The members will jointly and severally guarantee the new money issued by the Corporation, and also undertake that no money be put into circulation unless it is fully covered by bills in hand. The value of bills discounted, and consequently the amount of money in circulation, must be strictly adjusted to the existing requirements of Trade. Consequently there will never exist either a dearth or a superfluity of cash. The rate of discount charged must invariably be so adjusted that the purchasing power of money is kept as steady as possible."

Mr. Lowenfeld thus endeavours to unite in his scheme the beauties of the self-paying bill and the self-redeeming note, and regulation by expansion and contraction of cash, and also the price of credit. The strict adjustment to the requirements of trade would be likely to be a matter of difficulty, but he is working along the same line as the scientific stabilizers who will be considered later.

Another assailant of the gold standard is Mr. C. J. Melrose, who in *Money and Credit*

(Collins, 1922) argues for a currency of which each unit shall stand for a "true credit" and be a certificate of delivery—"a just demand to the return of an equivalent for what has been given up to be consumed by others." It will be noted that his expressions are somewhat vague, but his book is dignified by a "Foreword" from Professor Irving Fisher. Mr. Melrose contends, very truly, that his certificate money "is wholly within human control and only requires strict honesty and the aid of reasonable precautions to eliminate fluctuations entirely." But these requirements are, at present, rather a large order; and in the matter of money human control has not, in the last nine years, covered itself with glory.

An original touch in the attack on the gold standard is provided by Mr. Chas. P. Isaac who, in *The Menace of Money Power* (Jonathan Cape, 1921), implies that it is the cause of bad weather and bad harvests. He says in a Note to page 110: "It is interesting to note that, while bad harvests are usually thought to be the cause of financial crises, the truth seems to be that credit restrictions generally precede had harvests. The harvests prior to the credit restriction of 1826 (when notes under £5 were prohibited) were exceptionally abundant. Those following the Act of 1833,

which allowed the Joint Stock Banks, were similarly plentiful. The harvests of 1842-44 were very good, but when Peel's Act was passed bad harvests resulted"; so now we know why we had such a miserable summer in 1922.

CHAPTER VII

A NEW WAY TO WEALTH

ALL these difficulties that we have been feeling and expressing about our own monetary system at home have been greatly increased and complicated abroad by the much madder orgy of money manufacture that went on in other countries and in some of them has gone on unchecked. It need not be said that to those of our home reformers who thought that the way to salvation was through more money, the Continental example was most alluring. Mr. Kitson, for instance, in his little book on Unemployment that has already been quoted in interpretation of Major Douglas, uttered on page 7 a glowing appreciation of the most notable example of the system's working.

"The German Government," he said, "refused to enslave their people during or since the war by borrowing from the world's money-lenders to the extent and in the manner our Government have done. They used and are still using their own national credit in the form of paper money instead of borrowing the

credit of others, and they were not afraid of meeting the usurer's bogey—*inflation!* What have been the results? Although they suffered a terrible military defeat and are compelled to pay a war indemnity, they are to-day the most prosperous industrial nation in Europe. *They have escaped the ruinous interest charges with which we and France are burdened!* Their factories are running full time and they have but a very small percentage of unemployed—far, far less than any of the allied nations. Their industries are earning fabulous profits. They realize by experience that their cheap currency gives them an enormous advantage in trade competition over their rivals who are still deluded by the gold standard dear-currency theories! Hence they are capturing the world's markets as fast as their factories are able to turn out the goods. In short, whilst our orthodox Economists, financiers and Government officials are doing their best to strangle British enterprise by reviving their old and exploded financial theories, our sworn foe is invading our markets, capturing our trade, and that of our allies by adopting the very policy our orthodox Economists have condemned as impracticable and ruinous."

This passage is taken from Mr. Kitson's Foreword, which is dated May 20, 1921. It

is rather difficult to understand how Major Douglas's scheme, which was Mr. Kitson's final remedy, would be applied to foreign trade. In Mr. Kitson's explanation of its working in the coal industry he merely says that "the price of coal for export shall be fixed" (he does not say by whom) "from day to day in relation to the world market and in the general interest." Obviously the coal would have to be sold at a price that could compete in the world market, and presumably the difference between this price (if too low) and the cost of production would be made good, as in the case of coal sold at home, by a draft from the Treasury on the national credit account; and the final results of this system have already been exposed by the Labour Party Committee's analysis.

In Germany there was no cumbersome machinery of a Douglas scheme; it was just a question of straightforward printing; firstly because the Government (like most others then and at most times) found some difficulty in otherwise balancing its Budget, secondly because for some years after the war the general confidence in Germany's recuperative power caused an enormous demand all over the world for German marks as a speculative "lock up" that was certain some day to go back to its

old pre-war value; thirdly, perhaps, because the amounts that Germany was to pay in Reparations had not been settled and the German Government, very naturally from its point of view, was not at all eager to set its finances in order, but preferred that their chaotic conditions should give as unflattering as possible an appearance to the country's capacity to pay; fourthly because the actual payments that Germany made increased the difficulties of her position. And so the amazing process went on, by which, according to some estimates, gamblers in German currency lost as much as Germany has paid, and the Reichsbank's note issue has been multiplied so many times that the figures of its weekly returns are on an astronomical scale.

It is most interesting to consider that a really acute financial observer foresaw before the Armistice, and tried to prevent, the danger to which unlimited printing powers left in the hands of the defeated countries exposed them and the rest of the world. Dr. Alois Rasin, the late Czecho Slovakian Finance Minister, relates in his book on the *Financial Policy of Czecho Slovakia during the First Year of its History*[1] that when he took office he meant,

[1] Published for the Carnegie Endowment by the Clarendon Press

at first, to stop inflation by means of international intervention. "I requested," he writes (page 26), "the Minister for Foreign Affairs, Dr. Edward Benes, who was then staying in Paris in connexion with the settlement of the Armistice conditions, to endeavour to have an International Commission appointed to control the German Imperial and Austro-Hungarian Banks, whose duty should consist in the prevention of the issue of bank notes not covered by private liability in order to put a stop to the inflation. . . . This idea of international intervention came to nothing, either because the nations with sound currencies could not imagine the terrible conditions of a paper currency inflation and its disastrous consequences, or because they were not in the humour to champion the rights of the conquered."

Dr. Rasin must surely have written the passage about nations with sound currencies with a gently malicious intention. At the time of the Armistice it would have been difficult to find a country whose currency had not been debased during the war, and most of the Entente Powers, if they had understood the Czecho Slovakian proposal, would have hesitated to enforce on the conquered Governments a financial ideal which they saw no chance of

reaching for themselves. It is also very doubtful whether such a prohibition could have been carried out effectively. To tell the central bankers of Germany and Austria that they were only to issue more notes when "covered by private liability"—that is, in the supply of advances to private borrowers—would only have stopped note printing on Government account as long as official and financial ingenuity had been unable to find a way round the restriction. But it might possibly have been effective and the difference that it might have made to Europe's history in the past four years is almost incalculable.

But that is another story. In fact there was the inflation in Germany that gave Mr. Kitson the text on which he preached so eloquently as quoted above, in company with a host of other less emphatic and confident exponents of the inflationary gospel. At that time, in 1921, he had a strong case. Unemployment was on an enormous scale both here and in the United States. He was able to quote an American Trade Journal as authority for a statement that "currency contraction had thrown out of employment some 4,000,000, operatives, and in the inflating countries there were few or none out of work." Whether unemployment was caused here and in America by currency

contraction, reason has already been given for doubting: in both it was probably caused by the collapse of trade which followed the discovery, first made in the Far East, that if people stopped buying prices would fall back. But it is undoubtedly true that inflation, up to a certain point, stimulates the home demand for goods, and so maintains employment and also that, while it is proceeding, it gives a temporary help to the export trade of the country that indulges in it.

The benefit wrought by inflation in the home market is easy enough to see. Since inflation means multiplication of money in relation to goods and a consequent rise in prices it is clear that this process, especially when it goes so fast that everybody can see what is happening, makes folk eager to get rid of their money quickly, because it will buy less if they keep it another day, and to buy goods, because they will be dearer if they wait. Dr. Rasin describes very graphically, in the work already cited, the result of "want of confidence in the Krone" in Czecho Slovakia, even in its comparatively mild manifestations during the war. "Thus," he says (page 15), "with every failure of the Central Powers an aversion to the Krone set in, manifesting itself in the purchase of foreign currency (especially at the time before

the entry of the United States into the war), of securities expressed in foreign gold currencies, of national securities, and also of goods, furniture, clothes and linen. In these times peasant women sold only against materials and clothes and the wardrobes of the middle classes found their way into the villages, in exchange for flour, lard, butter and milk. The peasant women bought or bartered trousseaux for their daughters during the war; in many peasant cottages not only one but two pianos were to be found; and a peasant in the neighbourhood of Pisek, who already possessed every conceivable thing, finally bought himself a coffin with his paper Kronen."

It reminds one of Tony Weller's observation when Sam, consoling him for his bereavement, said that "there's a Providence in it all." "O' course there is," replied Mr. Weller, senior, with a nod of grave approval. "Wot 'ud become of the undertakers without it, Sammy?" (*Pickwick Papers*, vol. ii, ch. 24.)

Such a state of things sets up feverish and quite artificial activity in trade, because in the headlong flight from the Krone or the mark or whatever it may be, everybody who has marks or Kronen hurries to turn them into anything else. And so the ordinary household becomes like a museum or a ship-chandler's shop, stuffed with

a varied assortment of articles that are not at all wanted for the purposes of consumption, but are known to be going up in price because the currency is known to be falling in value because the Government is getting too much of it printed. Whether it is not better to submit to the evil of unemployment and meet it by a system of allowances as we did, than to avoid it by such an official swindle perpetrated at the expense of everyone who has, or expects to receive money, is a question that can be answered according to the taste and fancy of the inquirer. Mr. Kitson prefers the inflationary path and so did another manufacturer, Mr. T. B. Johnston, well-known in the pottery industry at Bristol, who wrote to the *Times* in August 1921 a letter in which he expressed, in more temperate language and with fewer italics and exclamatory ejaculations, conclusions much the same as Mr. Kitson's concerning the success with which Germany was capturing the trade of the world thanks to the inflation of her currency.

In this respect again it is easy to see that inflation, while it is taking place, gives a fillip to the exporter, because its effect upon rates of exchange, which are arrived at by chaffering among a set of exceptionally nimble-witted and well-informed dealers, is almost always much

quicker than its effect on domestic prices and rates of wages, which are largely a matter of habit and convention, and are only shifted after a new and gradual process of awakening. Thus the exporter who is paid in foreign currencies, turns them into a rapidly increasing amount of his home money, which has lost value at home much more slowly than it has abroad.

To make the matter clear by a concrete and extreme example, if we suppose that German currency was doubled in one night, its value in pounds sterling would be halved much more quickly than its value in goods and wages in Germany. And so the Solingen manufacturer who was selling safety razors in England for a shilling would be able to turn his shilling into 100 marks instead of 50, long before the prices of the goods and labour that he bought at home had risen *pari passu* and so he would be able, if competition made it desirable, to take a much lower price in England and still make a profit at the expense of his employees whom he would be paying in money that had lost value, without their demanding more of it. If he took a lower price in England the British Consumer would benefit and the English manufacturer of safety razors would justly complain that he was being subjected to unfair competi-

tion caused by the depreciation of German currency. He would probably proceed to clamour for Protection and would be difficult to persuade that Protection in his own market would only make competition fiercer in neutral markets and would perpetuate the evil, which would best be cured by letting it work itself out.

It will be seen that both for the stimulation of home and export trade, the inflation must be continuous. As soon as it stops and the prices of goods are steadied at the new level arrived at, and higher home prices offset the advantage to the exporter from the large amount of home currency that he gets from his sales abroad, inflation is no longer a spur to production and export. Evidently therefore this remedy for unemployment, as advocated by Messrs. Kitson, Johnston, and many others, can only work for a time. There must be an end to the inflationary process and its apparent and questionable benefits. And its end, as seen in Russia, Austria, Poland and elsewhere, seems to be economic chaos, and a state of things which finally works its own cure because the country subjected to it is forced, with or without help from outside, to stop the process.

Even in its early and most flattering stages, there is a good deal of doubt about the extent

of the benefits in the matter of export trade, alleged to be wrought by inflation. At the time when complaints by British producers were loudest, of ruthless competition by Germans with the help of the depreciated mark, it looked as if there must be something else besides currency depreciation that was helping Germany. Because at that time currency depreciation in Poland and Austria—to say nothing of Russia —was very much more acute; it seemed therefore that if debasing the currency was the short cut to fortune through international trade, Poland and Austria ought to be the dangerous competitors rather than Germany. Moreover the surprising fact appeared that some of the competition by which British industry at the time of the depression that began in 1920 was most fiercely attacked came from countries the currencies of which were at a premium as compared with sterling.

For instance in October 1921 there was a debate in the House of Commons on a Trade Facilities Bill and various examples were given of the alleged helplessness of British industry in the face of its foreign rivals. Sir Fortescue Flannery told the House that a ship went aground in the North Sea. She was brought off and taken into a Thames dry dock and tenders were invited for repairs. " The lowest

Thames side tender was £6,700: a better one from the North of England was £5,500, but from Rotterdam a Dutch tender was received for £1,800." Naturally the ship went to Rotterdam to be repaired; but she herself had knocked a hole in the much battered bottom of the Safeguarding of Industry Act, designed to protect our industry against competition encouraged by depreciated currency. For this tender, offering to do a job for less than a third of the best British bid, came from a country with an appreciated currency. Sir Fortescue accounted for the puzzle by saying that Dutch labour is almost as highly paid as labour in the North of England, but the Dutchmen worked longer hours and were free from many of the restrictions that cramp the British workman's elbow, and employers were content with a smaller profit. It is true that Holland got steel from Germany at half the price of ours, but that could not account for the enormous difference between the two tenders. Better work, fewer restrictions, and organizers of industry who were not too greedy were the causes on this occasion of the foreigners' success and probably were in many of those that were ascribed to currency depreciation.

My own personal experience in the matter was also strange. I happened at about the

same time in the Autumn of 1921, to need a saw for domestic purposes, went into one of the best tool shops in the City and got what seemed to be an excellent weapon at a reasonable price. Then I noticed on the blade the name of an American maker and observed to the shopkeeper that it seemed queer, with the dollar below four to the pound and thousands of unemployed in Sheffield, that we should be buying American saws. He evidently understood about the dollar exchange and what it meant, for he said that it certainly was queer and what was queerer still was that in spite of all that we read about slackness in Sheffield he could not get half the tools that he wanted from English manufacturers, and was glad enough to be able to get some from America, while the Sheffield people were thinking about beginning to wake up.

It was thus evident that currency depreciation among its trade rivals was by no means the only cause that was depressing British trade. My excellent American saw had probably been sold here cheap because its maker had the sense to see that the way to set trade going again was to get prices down and give the poor old public—bled white by the tax-gatherer and the wage earner and the captain of industry—a chance of buying some cheap goods and feeling

for once that it was not being fleeced. Just as the cure for competition based on depreciated currency is to let the public have the goods as fast as the foreigner will turn them out and leave the foreign worker to find out that he is being swindled, as he very quickly would. Whereas what happened was that industry squealed, naturally wanting to have things arranged as comfortably as possible for itself, and the Government perpetrated the farce of the Safeguarding of Industry Act which was only redeemed by futility from being really mischievous.

And then there arose the curious belief that Germany was not only beating our trade by debasing the mark, but would surely be still more effective as a trade competitor if she had to pay an indemnity to the victorious Allies. So much so that it would pay England, as most likely to be affected by German competition, not to receive anything at all by way of indemnity from Germany. Fears of the consequences of the indemnity payment had been expressed by some of our leading statesmen even before the Reparation figure dictated by the Allies in their Memorandum of May 1921 had been agreed to by the Germans. After that, and during the very short time in which it was believed that Germany was really going

to make an effort to make the payment demanded, these fears became one of the burning topics of the day.

It will be remembered that by the terms of the Allied ultimatum Germany had to acknowledge a liability to pay £6,600,000,000, with another possible £150,000,000 to cover unadjusted claims and accounts. Even in the ultimatum, however, the chance that Germany would be able to pay any such sum was by no means taken for granted. She was ordered to create and deliver partly by July 1 and partly by November 1, "A" and "B" bonds for £2,500,000,000, and she was to pay £100,000,000 a year and a sum equal to 26 per cent. of her exports. It was estimated that this sum would produce another £50,000,000, and so she would be paying £150,000,000 a year in all, which would provide 5 per cent. interest and 1 per cent. sinking fund for the extinction of the debt, on the £2,500,000,000 imposed on her. The balance of £4,100,000,000 odd was to be represented by "C" bonds to be issued and handed to the Reparations Commission, but they were only to be handed over by the Commission to the countries receiving the indemnity, as and when it was satisfied that Germany was able to provide for interest and sinking fund.

Thus this Allied Ultimatum which has been so often held up to scorn and ridicule as an attempt at impossible and unconscionable extortion was in fact really rather an effort at moderation. It looks as if the £6,600,000,000 touch was put in to amuse the gallery in all the countries concerned, and produce an impression that the big promises that had been made might perhaps be fulfilled some day, while the actual amount definitely named was reasonable, and yet provision was made for the possibility that Germany's recovery might be much more rapid and complete than then seemed to be likely.

It was in fact a quite workable plan with one very important exception. The fixed sum of £100,000,000 a year, to be forthcoming at once, looked doubtfully large and one felt that it would better have been reduced with an addition to the sum to be based on the volume of Germany's exports. Nevertheless there seemed to be first a possibility that the scheme might work. But it was not to be. Such opinion here as had long been eloquent on the theme that the Allied claims on Germany were extravagant and impossible, loudly proclaimed that the task imposed was too heavy. These vociferations helped to make themselves true by frightening speculators in German marks

into throwing them on the market and so putting the exchange against Germany and making it more difficult for her to make payments. Her first payment was handled by the Reparations Commission with a clumsiness that was amazing and upset the exchange markets much more than was necessary or healthy. The depreciation of the mark, due to these external causes, reduced its purchasing power at home and so made the task of the Government in making both ends meet all the more difficult, because expenses went up faster than the proceeds of taxes imposed before the fall, and so the Government, which was perhaps pleased to see its efforts to pay thus defeated, printed more and more notes to fill the gap and so made matters worse, and the vicious circle spun round faster and faster and continued to do so till its pace was still more quickened by the Ruhr occupation and passive resistance. And now some people say that it is all France's fault!

To the voice of the German sympathizers who said that Germany could not possibly pay, was added that of those who maintained that Germany could only pay by damaging our trade. This view was put by Mr. McKenna with all that lucidity and force for which his utterances are so justly noted. In a paper read

what he endured in the war he is tolerably well off."

Mr. McKenna went on to show that since Germany and Great Britain were by far the greatest exporters of manufactured and partly manufactured goods before the war, the brunt of the competition which her indemnity effort would produce would fall upon our trade, and suggested that in order to avoid the grave damage to us that would be involved by Germany's meeting her obligations under the Reparations scheme, Germany should be required to send to this country and to France and the rest of the Allied countries, to each according to its requirements, articles such as coal, timber, potash and sugar, all of which she produces in large quantities. He admitted, however, that by these means nothing like the agreed figures of the indemnity figure could possibly be paid, and did not explain why France should be expected, because we did not like the prospect of fierce trade competition, to reduce her demands upon Germany. Indeed there can be little doubt that the frankness with which the effects of the indemnity payment were discussed here in the light of its expected damage to British trade, must have been one of the reasons why France later on decided to take a line of her own in dealing with Germany,

rather than proceed in step with a leisurely partner who seemed to fear nothing quite so much as success in getting payment from his late enemy.

A Memorandum dated May 17, 1921, and addressed to the Prime Minister by the employers and workmen of the Iron and Steel Industry expressed its grave concern "at the possibility that, unless there is a rigid control of the whole of Germany's export trade, any Reparation settlement will have the effect, either by maintaining the exchange in a depreciated condition or otherwise, of encouraging the general export trade of Germany."

In June of the same year Mr. Edgar Crammond, well known as a bold and hard-working statistician, was telling the Bankers' Institute that Germany would "become the central workshop of the world, although operating under depressing conditions and at famine wages; her central shop would stretch out its tentacles to all markets of the world, aided by the boundless passion and tenacity of a people fighting for its life with the whole force of its concentrated productive machinery."

Fears such as these echoed by statesmen, bankers, statisticians and producers must have been balm to the spirit of Germany, showing her that important classes here feared the

effects of her payment and would thus be most reluctant to press her: time and currency chaos were on her side; she only had to leave things drifting and go on printing notes and she might, with luck, escape the indemnity payment altogether.

How much ground was there for these fears? They always seemed to me enormously exaggerated if not altogether baseless. Of course it was easy to make our flesh creep by imagining the scope of the trade that Germany would have to do before she could place an export surplus of £400,000,000 a year at the disposal of her victorious enemies. But that was most unlikely to happen and could only happen if the world at large had shown an effective demand for industrial goods such as would have justified the hopes of tremendous trade expansion that were current at the end of the war.

That she could provide a surplus of £150,000,000 a year, the figure at which she was asked to begin, and gradually increase it ought surely to have been a programme which need not have terrified British industry, because British industry would, from the circumstances of the case, have had a double handicap in her favour. For Germany industry would have had to bear the taxation involved by the

indemnity payment and British industry would have been freed from taxation to the extent of the share of the indemnity received by Britain. It is true that Germany, by wiping out the value of her currency, has also wiped out her internal debt, incidentally ruining her investors; but taxes imposed for purposes of payments abroad have a much heavier weight than those which are merely collected to be paid out again at home; if Germany had to turn goods into dollars and relieved us from this uncomfortable duty laid on us by our debt to America, then with this double advantage British industry, if its organization and spirit were fit to carry on the tradition of those who had built it up, ought to have been able to deal so effectively with German competition that Germany could only have been able to pay the indemnity by supplying markets which Britain, for reasons entirely of her own, was prepared to leave her.

And surely it ought to have been obvious that the German competition which was thought so formidable, was not going to be made more so by the indemnity payment, because German industry was certain, whether an indemnity was imposed or no, to make every effort to sell goods all over the world.

But this was a time of curious delusions, and many people, even among those who were cry-

ing out loudest against the high taxation that was alleged to be strangling our own industry, were quite ready to talk in a way that implied that the imposition of an indemnity on Germany, and the high taxation involved by it, were going to make German industry work all the harder and all the better.

And so we seem to be led to the curious conclusion that the royal road to the capture of the world's trade lies through two gates, the first of which is currency debasement, and the second is the obligation to pay a crushing indemnity. But was there any reason to suppose that because the German employer and workman were going to be taxed to pay an indemnity they would therefore work harder and better? Perhaps there might be a few highly patriotic souls who could really maintain such an effort in order to free the Fatherland from economic bondage. But to most of them—though German patriotism is surely a marvellous force—the effect of this payment would seem to be more likely to have a damping effect on the daily and yearly effort. If there were no indemnity to pay and all that German industry earned went into its own pocket and that of Germany, then one might well imagine that the "boundless passion and tenacity" spoken of by Mr. Crammond would

be devoted to the recovery of the economic strength of the Fatherland.

More than a year later—in October 1922—Mr. McKenna was discoursing on the subject of Reparations and International debts, at an American Bankers' Association Convention, held in New York. He reminded his hearers of the results of the payment of the French indemnity after 1871, and Bismarck's observation that the next time he defeated France he would insist upon paying an indemnity; and went on to show that in spite of full employment and hard work in Germany and the advantage given to the German exporter by the falling mark (" so much so that there is hardly anywhere a manufacturer, producing goods for export, who does not complain of German competition ") German exports " are still barely equal to imports " and " the conclusion seems inevitable that Germany has no present capacity to obtain a surplus from the export of goods." Further, that if she could pay she could only do so by exports of manufactured goods, in the teeth of competition, and the result would be that she and her competitors would work longer for less wages, cut profits and reduce imports, and that a " general lowering of the standard of life " would result.

But surely this would be a most curious effect to follow a great flood of production of cheap goods poured out upon a world which for years had been suffering from scarcity and dearness of goods and over-production of money. From the point of view of the tax-payer and consumer—and we are all of us both—the effect of a big indemnity payment on the countries that receive it would seem to be highly beneficial, if it is used wisely and is not allowed to promote inflation and inflammation as happened in Germany after *1872*. We at least could always have made an excellent use of any money that we were likely to receive from Germany by using it in payment of our debt to America, and after that if there were anything more, in restoring the foreign investments that we had to sell during the war, to the detriment of our strength as a financial centre. Mr. McKenna, however, seemed to think that not only could Germany not produce an exportable surplus, but that it was equally impossible for France or any of the Allied debtors. He thought that Germany could pay something, namely the amount of her foreign assets which he estimated at a billion dollars—£200,000,000. England he showed to be the only debtor possessing any large accumulation of foreign assets—enough

to cover her debt to the United States two or three times over. France and Italy he believed to have no similar reserves, and so he concluded that "these international debts are far too great for the capacity of any of the debtor countries except England."

My own view has already been expressed that France and Italy ought to have been released from their debts to England on the day after the Armistice, and that this act would have cost us nothing, and would have had an immeasurable effect for good on Europe's financial atmosphere. But Mr. McKenna surely proves too much in implying that it is not possible for a nation like Germany, gifted with great natural resources and with unrivalled powers of work and application, to produce a very considerable exportable surplus if she made the necessary effort and the necessary diversion of her productive power.

For how, except by producing an exportable surplus, can England and Germany have in the past accumulated the foreign assets which now alone, in his view, give them the power to make payments abroad? Germany may have done it by selling marks to speculators. But we, as Mr. McKenna shows in the course of this very address, have done it by doing just what he seems to think that Germany

cannot do. "For over two centuries," he said, "British capital has been lent to other countries. Year by year England produced more than she either consumed herself or could exchange for the products of other nations, and she could not obtain a market for the surplus unless she gave the purchaser a long credit. Foreign loans and foreign issues of all kinds were taken up in England, and the proceeds were spent in paying for the surplus production." Quite so; we had an exportable surplus, and sold it abroad, giving credit to the buyers. When we think of all that has been said about Germany's power to compete, there seems to be no reason why Germany should not provide an exportable surplus, and sell the goods and services abroad just as we and she and perhaps other countries were doing before the war. As we all remember in those days her "peaceful penetration" in Italy, Mexico, Brazil, and other places was supposed to be a menace both to our trade and to our financial supremacy. What she did then in order to invest she can do now in order to pay her debts.

In fact it is very puzzling, in view of all the complaints of manufacturers about the cut-throat competition which Germany is alleged to have been carrying on, to account for her

recent failure to produce a big trade balance in her favour. If she was really capturing the world's markets as fast as Mr. Kitson and other people thought, her trade with the rest of the world should surely have been on a basis most satisfactory to herself. Yet we find that when a bevy of foreign experts, including Professor Cassel of Stockholm, Professor Jenks of New York, Mr. R. H. Brand, a partner in Lazard Brothers' London house, and Mr. J. M. Keynes, went to Berlin in the Autumn of 1922, at the German Government's invitation, to advise it concerning measures for the stabilization of the mark, it was faced by the difficulty, among many others, of determining whether the adverse balance of trade which was alleged to make stabilization impossible without help from outside, really existed. Finding itself unable to arrive at solid results from the figures supplied to it by the German Government, it made calculations of its own which brought it to the conclusion that the adverse trade balance could not be very great.

In view of the wild fluctuations in the mark it was naturally very difficult for Germany to present any trade figures which gave anything like a true picture of her trade, and the report of these sympathetic experts seemed to confirm the general belief that Germany—as was

most natural from her point of view—was not making serious efforts either to show what her industry was doing in the matter of exports, or to put any brake on the pace at which her finances were slipping into chaos. Why should she do so as long as there was a chance of reducing the Indemnity Bill by looking as bankrupt as possible? These learned gentlemen point out that "no other currency has fallen into decay with so great a potential support still unused," referring to the store of gold in the Reichsbank; and they call on the Government to practise economy and collect its taxes rigorously, and remind it that "capital expenditure for the public services should not be charged to revenue but paid for out of funded internal loans," thus showing that the Government had been printing notes not only to stop the gap between income and expenditure but also, for the provision of capital expenditure, which ought to have been paid for by loans subscribed to by investors.

In fact it seems very likely that the great additions made by Germany to capital equipment go far to account for her failure to balance her foreign trade account. It was noted above that in August 1921 Mr. T. B. Johnston, a well-known Bristol manufacturer,

had written to the *Times* echoing Mr. Kitson's contention that Germany's currency policy was winning the world's trade for her. His views having been questioned by the *Times* City editor and others, Mr. Johnston sent over a qualified investigator, Mr. E. S. Dane, to look into the state of Germany. Mr. Dane wrote an interesting and impartial report, published under the title of *What is Germany doing?* Mr. Johnston, in his preface to it dated July 1922, says that its findings largely substantiate his early contentions, and that "huge profits are being made by the German industrialists on their export trade." And yet Mr. Dane, when he came to the trade figures, was also tempted, without doubting the sincerity of the statisticians, to consider whether the figures were accurate. "Taking English and American returns as a basis," he added, "it seems that Germany does not yet export goods in the ordinary way of commerce to nearly the extent which she did before the war." He maintains, however, that the export trade is undoubtedly thriving, though he goes on to admit that many foreign orders have been cancelled recently owing to unsatisfactory delivery.

He thus leaves his readers puzzled and bewildered as all investigators must who in 1922 tried to find out what Germany's export

trade was doing, but incidentally and as by a side-wind, he blew to bits the contention of Messrs. Kitson and Johnston that there was no unemployment in Germany. They were quite right in a sense because the unemployed were got rid of by putting two men to do one job. " Government offices," he says, " are enormously over-staffed, and the late Dr. Rathenau estimated the number of 'Invisible unemployed' at four millions. Taking into consideration the decreased area of Germany, officialdom experienced an increase of 49 per cent. in 1920, compared with 1914—a remarkable figure considering the disappearance of the army and navy." It certainly is a remarkable figure and helps to account for many things. But it was on the point of capital expenditure that we turned to Mr. Dane. " Capital construction," he says, " is being indulged in on a colossal scale; one sees new factories and buildings, the latest machines, and improvements everywhere. Germany is, in fact, going through much the same phase in an intenser form as we experienced in the days of E.P.D. The causes in her case are the finance policy, the non-collection of taxes and the ever-rising prices, which make construction cheaper to-day than it will be to-morrow. . . . We have the anomaly of a

bankrupt nation preparing for the greatest building boom on record, equipping a floating exhibition ship to capture foreign markets and inaugurating huge canalization, electric power and other schemes."

From all this mass of queer and conflicting evidence it will appear that if Germany has not an exportable surplus at present, she is very well equipped for getting one as soon as it is made clear to her that it will pay her best in the long run to try to meet the payments demanded on indemnity account. "With a properly limited currency," said Professor Cannan in one of the *Manchester Guardian Commercial's* "Reconstruction" numbers, "Germany will soon find her feet again and be able to pay a good deal, if she is willing. I have no patience with those who imagine that how much she can pay can be discovered by an examination of her balance of trade, either before the war or now. One of the most certain things in economics is that a country's balance of trade depends on what she chooses or is obliged to pay." Just as we, as Mr. McKenna showed, year by year produced more than we consumed and lent the balance to our customers, so Germany can produce more than she consumes and pay the money raised by her sale of the balance to her

creditors or to parties named by her creditors. It will be remembered that Mr. McKenna's interesting analysis pointed out that we could not obtain a market for our surplus unless we gave the purchaser a long credit. Under present circumstances this difficulty of a market is solved, in part, by the fact that all the Allied creditors of Germany are debtors of the United States, and that the United States with their huge consuming power can hardly refuse to admit European goods in payment of what is owed them by the Allies. It is true that they have lately put their tariff wall up a little higher in accordance with the prevalent fashion by which the Governments of the world, having solemnly agreed through their representatives at a Brussels Conference that the exchange of goods between all countries should be furthered in every way, are doing their utmost to restrict it, by tariffs and preferences and licences and other devices dear to the politician and the bureaucrat, and exasperating to the business man except when they keep out goods that compete with what he makes or owns. But in spite of their raised tariff the United States have been buying more and selling less, as a creditor must unless he will go on lending more.

As far as we are concerned all that we are

likely to get from Germany for some years to come can be paid by her through the sale of goods to America, or to other countries from which America takes goods. If the time comes when our share of what she pays is more than we need for the service of our debt to America, then we shall have to lend to other countries that want loans the proceeds of the goods that Germany exports on our account. For example Germany can build railways in Russia, or if Russia has not returned within the economic community of nations, in Hungary, Rumania, Brazil or anywhere else; and Russia or whoever it may be will owe to us the railway which Germany will have built on our account and so we shall rebuild part of our fabric of investment, so much of which had to be pulled down during the war and exchanged for things that were more pressingly needed.

Some of our manufacturers will, like true Britons, gnash their teeth at the thought of anybody but themselves selling anything to anybody; but let me remind them once more that they will have a big enough pull, in the taxation laid on Germany and escaped by us through the indemnity, to enable them to beat Germany when they want to; to say nothing of the fact that they seem to be able to hold

their own as it is, partly because a British contract is preferred; at least in the Federation of British Industries Bulletin of July 17, 1923, it was recorded that the Paterson Engineering Company of London had obtained the contract for a water supply for Reval, although several of the competing tenders, one of which was German, were lower than theirs.

Whence it follows that Germany can only pay an indemnity if the world has been allowed by its Governments to settle down into a state of sufficient political recovery and tranquillity to enable the manufacturer and the merchant and the financier and the investor to go forward in confidence to a great effort of expansion and construction and reconstruction. There is an enormous amount of work waiting to be done, millions of people wanting to do it, other millions wanting it to be done, and thousands of organizers and financiers ready to start it and carry it through, if the statesmen who are supposed to interpret the will of the nations would only get out of the way and leave free play to mankind's entirely sensible instinct in favour of growing, producing and exchanging the goods that it needs for its comfort.

If such a state of things could happen Germany's capacity to pay would look very different. By her policy of currency debase-

ment she has wiped out her internal debt a also the debts and charges of her industry a her agriculture. And even now after all t we have heard about the impossible dema of the Allies, it is quite likely that Germa may yet prove to have been let off much t lightly, unless someone can devise some inge ous scheme by which the Allies will ben from an unexpectedly quick recovery of h economic strength, without discouraging h effort to secure it.

CHAPTER VIII

THE NEXT STEP

FOR purposes of this merely popular discussion, there is no need to go more deeply into the Quantity Theory of Money than to recognize that if money, by which we mean any coin, or bit of paper, or other article that is commonly taken in payment, is multiplied and circulated faster than goods come forward for sale, the general level of prices will go up and *vice versa*. From this it is any easy and alluring jump to the conclusion that changes in the general price level need no longer happen, and that by regulation of the quantity of money the price level can be kept steady or moved up and down to any point that we like to choose. If so we have found what the old critics of our gold standards have for many years been seeking and we have got, in regulated paper, a standard that shall be as trustworthy as a yard measure. Mr. Kitson—or his particular embodiment which sought for stability rather

than the moral right of everybody to all the credit that he wanted—and Professor Soddy join hands with some of the most distinguished exponents of economic science, Irving Fisher who for years has been hammering away like a Trojan at his plan for " stabilizing " the dollar, Gustav Cassel, the great Swedish master who ever since the Brussels Conference has been imploring mankind not to add the folly of deflation to the crime of inflation, and J. M. Keynes and R. G. Hawtrey, the brilliant English champions of stabilization. What we humbler mortals have to consider is firstly whether stabilization is as simple a matter as it seems: secondly, whether, even if it were all that its admirers claim, it is wise to widen the power of Government, especially in a field in which it has blundered with unusual vigour and recklessness; and even though the actual regulation were put into the hands of the Bank of England, Parliament would, I think, certainly claim the ultimate right of control. Thirdly, if we do decide to stabilize, at what point we should steady our price level.

After giving the above list of names in favour of stabilization, it seems almost profane to suggest that this doctrine involves big assumptions; but surely the Quantity Theory, as any complete statement of it must show, depends

for its truth not only on the quantity of money in relation to things to be bought and sold but on the use that is made of the money by its holders, that is to say, on the velocity or slackness of its circulation. You may contract and expand—if you can—the volume of currency and of bank credits like a concertina, but if the public makes a nimbler use of the scantier currency and credit left after contraction, and leaves idle in its pocket and in its bank balances the larger amount produced by expansion, the effect on prices will be little, if any.

And the original contraction and expansion is not going to be as easy as it looks. Professor Soddy told us all about one way of doing it, dismissing it in a couple of sentences as a thing which went without saying. "Currency," he said, "must be regulated *pari passu* with the changing revenue, issued as the latter expands and destroyed as the latter contracts." (It should be noted that the Professor when he talks of revenue does not use the word in its ordinary sense, of the Government's income, but means the whole income of the whole nation.) "Since it would neither be given away in the first nor taken away in the second event, but used to buy back old, or taken in exchange for new State loans, the community as a whole would share the prosperity of good

times as well as the stringency of bad ones, instead of only the latter as under the existing system." Why our peevish friend should suppose that the community as a whole does not share the prosperity of good times we need not pause to inquire. What is curious is to find his system of currency regulation depending on the existence of a national debt, in view of the many eloquent passages in his pamphlet which are devoted to denunciations of usury. The fact, however, that only a nation with a debt can use the system is never likely to be an objection.

In this country the system would work, I suppose, somewhat on this wise. If prices went down and it was therefore desired to increase the volume of currency, the official broker would be sent into the Consols market to buy the necessary number of millions of Government securities, and new notes, either Treasury notes or Bank of England notes, would be issued to the sellers in payment for their stock; this would be a simple and inexpensive operation. Interest bearing debt would be paid off by the issue of paper which would only bear the cost of printing.

But when it is the other way and debt is issued so as to contract currency at a time of rising prices, the process seems likely to be

both expensive and unpopular. No use could be made by the Government of the currency received from subscribers to the new loan; it would have to be destroyed, to carry out the scheme, and so the operation would be dead loss; at a time of expansive prosperity implied by the circumstances the Government would probably have to pay a handsome rate to get its loan out, and it would have to lay this sacrifice on the shoulders of the taxpayer, knowing that thereby, if the measure succeeded, it would be checking the rise in prices that makes the business world so happy.

There would probably be plenty of people who would argue, that the Index Numbers, which are supposed to record the average movement of the prices of the principal commodities, were all wrong, and that prices are not really rising at all. Dr. E. C. Snow in an article in the *Manchester Guardian Commercial* of July 19, 1923, observed that "the perplexity in which those who have attempted to make practical deductions from the movements of price Index Numbers in the past few years have been placed is sufficient evidence of the inadequacy of these Index Numbers for the purpose." And as I write in August of the same year, a dock strike is still going on which began because the dockers, whose pay was to be

reduced because an Index Number had fallen, knew, or thought that they knew, that there had been no fall in the cost of living which the Index Number was supposed to record.

Mr. Kitson, in his expansive embodiment, would be saying that " sales are limited by the amount of money or credit offered "; that "production is necessarily limited by the quantity of money or credit available for commercial purposes"; and that "a study of the currency and bank methods of all industrial nations for the past century will convince every unprejudiced person that the scarcity of wealth and the limited amount of production has been due primarily to the legally restricted supply of money." (*Money Problems*, page 32.) One can hear the rattling cheers of the Opposition back benches as the leader of the Kitsonian party makes his points, and convicts the cowering Administration of throttling, at the bidding of misleading statistics in which nobody believes and armchair economists with cosmopolitan leanings, the industry of England just struggling to expand.

Professor Irving Fisher will always be associated with the rise of stabilization to the position of an ideal, for which people were ready to work. His system is expounded in his well-known work on the *Stabilization of*

the Dollar published in 1920, but the first sketch of it was outlined in 1911, in his *Purchasing Power of Money*. It has always seemed to me to be rather too clever and complicated for the public ever to understand, and that it would therefore always be received with suspicion and made responsible for earthquakes, harvest failures, and epidemics. Professor Fisher, in his own summary of his scheme, says that his method is "to vary the weight of the gold dollar so as to keep its purchasing power invariable. We have now a gold dollar of constant weight and varying purchasing power; we need a dollar of constant purchasing power and therefore of varying weight. . . . If prices tend to rise or fall, we can correct this tendency by loading or unloading the gold in our dollar, employing an Index Number of prices as the guide for such adjustments. The process for doing this is as simple as clock-shifting for daylight saving and would produce its effects unobtrusively."

The plan has now been embodied in a bill which has been introduced in the United States House of Representatives and referred to the Committee of Banking and Currency. Its working is explained as follows by Mr. T. Alan Goldsborough, a member of the House, in the January 1923 number of the *Proceedings of*

the Academy of Political Science, New York:

"The mechanism of the bill provides for the retirement of gold coin by the payment of a small premium, leaving gold certificates, or yellowbacks, in circulation. There will then be a certain number of dollars in gold in the Treasury either in gold coin or gold bars. Should the general wholesale commodity price level rise, say, 1 per cent. in a given period (two months in the bill), the amount of gold in a gold dollar is increased arithmetically 1 per cent., which leaves 1 per cent. less of gold dollars in the Treasury, which necessitates the retirement of 1 per cent. of the yellowbacks, which in turn contracts the total volume of potential money and credit by 1 per cent. This process is followed every two months until the price level is down to normal. Should the price level fall below normal, say 1 per cent., the amount of gold in a gold dollar is decreased 1 per cent., which increases the number of gold dollars in the Treasury by 1 per cent., which permits the issuance of 1 per cent. more of gold certificates, which in turn increases the potential money and credit throughout the country by 1 per cent."

Clock-shifting for daylight saving, if it happened whenever the thermometer moved,

would be a most unpopular arrangement, and there is reason to fear that Professor Irving Fisher's scheme would be a cause of much bewilderment, and that if it were adopted by a large number of nations, it would make questions of exchange more difficult than ever to unravel. It is easy to answer this objection by saying that the scheme is quite simple to those who are clever enough to understand it, and that its working would naturally be entrusted to such folk. But the general public, I think, has a rather well-based suspicion of schemes that can only be understood and carried out by very clever people.

Professor Lehfeldt of Johannesburg, however, who really understands these matters, says in his clear and excellent *Restoration of the World's Currencies* that the Fisher plan is not only ingenious, but has serious practical merits to recommend it. He has no doubt that the system would work and that it would confer great benefit on a world plagued with ill-regulated currencies; "it would, however," he adds, "be necessary to convince the commercial and political classes of its merits," thereby seeming to imply that neither of these classes is likely to show much eagerness in making the mental effort necessary for grasping the beauties of the system. Professor

Lehfeldt decides that the simple gold standard being familiar to everyone should first be restored to get us out of our present distresses, and that after that we can go on to discuss new devices and improvements.

Regulation by discount rate remains as a third method of controlling the volume of currency, and at present perhaps the most fashionable among reformers—especially those who may be referred to with no intention whatever of disrespect as academic. In this country and in others where legal tender currency is only used in wages payment and retail transactions and as the bankers' cash reserve against deposits, the amount and circulation of "bankers' money"—bank deposits and cheques drawn on them—is evidently a most important influence on prices. When we have all got growing balances at our banks and are constantly turning them over by drawing cheques against them, a rise in prices is certain to happen unless the volume of goods coming forward for sale is growing as fast as the figure of our bank balances.

These bank balances are contained in the deposits held by the banks[1] and it has been shown that these deposits are created by the banks in making advances, discounting bills

[1] See balance sheet on p 20

(Treasury Bills or the bills of exchange of commerce and finance) and investing in securities. If then the bankers raise the rate that they charge for advances and discounts it is easy in theory to assume that those who have borrowed from them will be inclined to repay advances and discontinue discounting, and that there will thus be a reduction in bank balances and a consequent fall in prices; and *vice versa* when the banks lower the rates that they charge for accommodation borrowers will be encouraged, deposits will expand and prices will go up.

And so we proceed to the ideal set forth by Professor Cassel of Sweden, of a "true bank policy." He tells us on page 103 of his work on *Money and Foreign Exchange after 1914* that "the supply of credit must be so regulated that no rise in prices and, naturally, no fall in prices either, takes place. In order to keep demands for credit within the limits of available means, the banks must apply interest rates fixed with that object in view, but in their continual scrutinizing of the demands for credit must also be able to effect the necessary restrictions. The main factor determining interest rates throughout the entire banking system in a country is the central bank's discount rate, and in addition the central bank naturally possesses

a very great influence owing to the general advice it is able to give to private banks as to their credit policy." A little later he says that "a fixed value (of the monetary unit) can only be kept up by properly limiting the granting of credit and principally, therefore, by a suitable discount rate."

Now this scheme of regulating prices through credit contraction and expansion, brought about by raised and lowered rates for loans, the rises and falls of which were prompted by movements in the central bank's official rate, was tentatively, and as I venture to believe quite ineffectively tried in this country in 1919 and the following years. As was shown in Chapter V the rises in Bank Rate in 1919 and 1920 were certainly followed by a catastrophic fall in prices, which, however, was accompanied by a further expansion in bank deposits. It was clear that to produce actual contraction of bank credits, under the circumstances then ruling, Bank Rate would have had to go up at a pace that would almost certainly have precipitated panic. The fall in prices happened not because banking credits had been contracted—because they had not—but because, stimulated by the Chinese example, consumers all over the world stuck in their toes like an overburdened, over-beaten ass and refused to

go any further. Professor Cassel admits on page 226 of the work already cited that "the common purchasing strike, both on the part of business enterprise and consumers, may perhaps be regarded as the immediate cause of the fall in prices. But this purchasing strike," he adds, "has been a direct and natural consequence of the restrictive policy adopted by the bank administration." The Professor might have explained how a restrictive policy which failed to restrict could have produced a fall in prices.

In 1919, however, conditions were quite abnormal, with prices soaring so fast and furiously that producers and merchants might well think that hardly any rate for money could make it advisable to take in sail. In normal times a few turns of the Bank Rate screw might certainly be counted on sooner or later to produce the desired effect. But when the wind is on the other cheek, when depression prevails and it is desired by lower money rates to induce enterprise to tuck up its sleeves and get to work, no such success can be expected with any confidence. If people think that any business that they do is likely to involve them in loss, they would evidently be born fools to do it, even if the money needed was lent them for nothing.

This difficulty is admitted even by Mr.

Hawtrey, whose belief in the overwhelming influence of monetary conditions on trade is carried to such amazing lengths in his brilliant and interesting works. In his *Monetary Reconstruction*, page 142, he says that "even lending money without interest would not help, if the borrower anticipated a loss on every conceivable use that he could make of the money. . . . But such a condition of stagnation is not possible except in the course of reaction from a riot of inflation. If the inflation is prevented, the stagnation will never arise." It must indeed be pleasant to possess a mind like Mr. Hawtrey's that can arrive at this completely confident certainty about matters which to ordinary mortals seem to be so full of doubts, difficulties and complications. How does he know that if there has been no previous inflation there can be no business stagnation? Might not stagnation arise from political or social upheaval or apprehension thereof, or from the effect of a plague or the failure of a harvest which might seriously disorganize the business of the world?

Surely the price that enterprise has to pay for the use of money is only one among very many items that it has to consider when it is deciding whether to spread or take in canvas, or just to "keep her so," and it is a big assump-

tion to suppose that by varying this one item a certain and prompt effect can be produced on industry's decision.

This assumption, however, Mr. Hawtrey not only makes without an effort but expects the rest of the world to take on the strength of his personal pronouncement. "Whatever other factors," he says (page 143), "affect the purchasing power of the monetary unit, one, the volume of trade borrowing, is amenable to human control. By its means the agency which exercises the control, that is to say the Central Bank, can correct the effect of all the others." Hence it follows that, whatever disasters happen such as wars, plagues, pestilences and famines, trade will continue steadily on an even keel as long as the Bank of England makes appropriate use of its Bank-Rate weapon. "It is quite superfluous," our Mentor continues, "to seek for other causes of depression and unemployment when there has been so tremendous a deflation as to reduce prices by half in less than two years. . . . This does not mean to say that we do not suffer through the distresses of Europe. Our loss is heavy enough, but it does not take the form of Unemployment. Unemployment is due to a defect of organization, a maladjustment of the monetary machine. The

defect can be cured, the maladjustment can be corrected." So our lack of foreign customers and our failure to get peace, and the action of France on the Ruhr which so many have held responsible for our continued depression, have had nothing to do with our unemployment; and a new Gengis Khan might sweep over the whole of Europe and Asia with fire and sword from Pekin to the Bay of Biscay, and might then proceed to inflict the same inconvenience on North and South America, Africa and Australasia, but as long as the Governor of the Bank of England moves his official rate according to Mr. Hawtrey's directions, employment will go on steadily in England!

Well, one can only hope that Mr. Hawtrey is right, but the admissions which he himself makes seem to show that his theory is not quite as impregnable as his confidence. For he observes on page 120 that "a deflation so intense as to reduce prices of commodities by nearly 50 per cent. and to throw 2,000,000 people out of employment has been accompanied by no visible fall in bank deposits. And it is even argued that there has been no deflation at all, as if the quantity of purchasing power were the sole test of the state of credit. The kind of deflation that is practically

important is deflation not of the outstanding aggregate of purchasing power but of the *flow* of purchasing power" But this new complication seems to upset the whole theory of the control of prices through money rates There is a great deal to be said for the belief that higher rates will tend to restrict the volume of credit, as long as this belief is not pushed to extremes But now Mr Hawtrey, finding that the fall of 1920 was not produced by a restriction of credit, because credit was not restricted, begins to bark up quite a new tree and tells us that what really matters is restriction of the flow of credit

Everybody recognizes that the effect of the quantity of money in relation to goods in raising and depressing prices is complicated by the pace at which the owner of the money turns it over, and this is one of the reasons why some of us doubt the efficacy of the remedy that Mr Hawtrey proposes for all our economic ills But it seems to be making a new claim on our credulity to expect us to believe that because Bank Rate goes up therefore people are certain to make less use of their bank balances and turn them over more slowly If the rise in Bank Rate makes them expect a fall in prices it may through psychological influence produce this effect But at the end of July 1914 we

remember that a 10 per cent. Bank Rate was accompanied by a consumers' panic and a scramble both for money and for goods.

It should be noted that Mr. Keynes expresses himself much more cautiously than Mr. Hawtrey on this subject of price regulation through control of credit. In a letter published in the *Times* of August 7, 1923, he only claims to be "supported by expert opinion in the belief that . . . it lies in the power of the Bank of England and the Treasury, within wide limits to determine in the long run how much credit is created." and he argues that "the policy of the Cunliffe Committee assumes that the authorities have the power in the long run to fix the price level, just as much as the policy of price-stabilization assumes it."

And Mr. Carl Snyder, statistician to the Federal Reserve Board New York, shows doubt of the efficacy of mere movements in the discount rate by proposing, in a scheme published in the *American Economic Review* of June 1923, to reinforce them by automatic increases and decreases in the Central Bank's holdings of securities and acceptances. But surely if there is one thing that a Central Bank cannot do, it is to refuse to lend or discount at a price If it is to become a merely automatic machine, with no elasticity or power of dis-

crimination, it will lose the greater part of its right to exist

Moreover even if the system of regulating the general level of prices through the discount rate were as certain and simple as its distinguished exponents believe, even if it were possible with Professor Cassel to lay down that "the supply of credit must be so regulated that no rise in prices, and naturally, no fall in prices either, takes place," should we then have removed from the minds of organizers of industry all fear of loss and from their workmen's all fear of unemployment? The Index *Numbers of the average price of commodities* would march, serenely stabilized, in a steady straight line across the charts that are so dear to statisticians But the leather merchant and the bootmaker might very likely say "A murrain on your Index Number, what's going to happen to hides?"

For it is these special fluctuations that affect one commodity and one trade and are not by any means lessened by the most successful stabilization of the general price level through credit regulation, that affect those who are concerned much more seriously than a movement in which all other prices are joining For instance, if wool rises or falls with other prices, the cloth maker and the tailor are comparatively

little affected. Their raw material is rising and their finished commodity likewise (or the rise in raw material could not go on rising long), but so also are all the other materials that enter into food, clothes, shelter, and transport. For a time, owing to the habitual "lag" in wages, they may earn an extra profit at the expense of those who work for them; but this cannot last and when it is over what they make on cloth and clothes is offset by higher prices for all the things that they have to buy. And in the case of a fall it is likewise, except that then the advantage of the lag in wages is on the workers' side.

But if wool, cloth and clothes go up or down when other things are steady or moving in the opposite direction, then there is a big gain or loss. If the cloth maker can make a bigger profit and buy other things more cheaply, or suffers a loss at a time when all that he has to buy is dearer, then it may be a question of fortune or of ruin, and such things are quite possible with a successfully stabilized Index Number. And in spite of Mr. Hawtrey's conviction to the contrary there is surely something to be said for the view that trade depressions begin owing to these special fluctuations in the fortunes of particular enterprises, which arise because of the uneven

pace of development and production in different industries, and spread to others like an unwholesome contagion.

If this be so, the notion that we can secure real stability in enterprise and freedom from unemployment, even if stabilization of the general price level were entirely successful, might bring with it grave disappointment.

Champions of stabilization are already arising who go all the way with Professor Cassel and Mr. Hawtrey but insist that when their goal is achieved it must only be a first step towards the stabilization of individual prices. Mr. E. M. H. Lloyd has lately produced a book entitled *Stabilization, an Economic Policy for Producers and Consumers*, which is all that a book should be in brevity and clearness and brightness. He is very eager and earnest, thinks private property in land and railways an "anachronism," and takes things for granted with an airy confidence that is very pleasant; as Mr. Edmund Gosse once said of a French theorist about Shakespeare, "he leaps to conclusions with the sudden agility of a chamois." He seems to think that because thirty-one Governments assembled at the Genoa Conference have officially endorsed the "important new doctrine, that the general level of prices, and consequently the general

state of trade and unemployment, can be to a large extent stabilized by appropriate action on the part of the Central Banks," therefore this so desirable stabilization may soon be expected. Was not there a Brussels Conference and did it not officially endorse balanced Budgets, cessation of finance by printing press, and inter-change of goods between nations, and have not most of the Governments which endorsed these ideals continued to spend more than their income from revenue and to maintain and increase restrictions on trade? And how long would it take before the Central Banks of Europe and America could really be got to work together and to hand over the control of their credit policy to the majority of a committee or whatever the machinery proposed might be?

Mr. Lloyd, however, leaves America out, on the curious ground that "so long as public opinion in the United States will insist on repayment of European debts not much progress can be made in monetary stabilization." Why America, whose interest in the war was so much remoter than Europe's, should be expected to lend huge sums for it and then remit them, he does not explain. Following Mr. Hawtrey and the Genoa Conference he proposes a European Monetary Convention

and a sort of European Consortium to be formed by the Central Banks, which would pool their gold. "Let us assume," he says, "for the sake of simplicity that all the gold is deposited in London." It would be simple, but is it likely as long as there is any possibility of war between any of the Powers included in the scheme? "Being thus linked together, with a single pool of gold, the Central Banks would need to pursue a common discount policy. In other words, the expansion and contraction of credit and the regulation of the volume of money and circulation would be effected by alterations in the Bank Rate at a common centre. This would virtually restore the state of affairs which existed before the war, when the London Bank Rate exercised a determining influence over monetary conditions in other European countries." How many French bankers would allow the truth of this last statement?

But as already indicated, the most interesting point in Mr. Lloyd's programme is that having taken the stabilization of the general level of prices in his stride, as secured by the Genoa resolutions, he goes on (page 79) to doubt whether stabilization "can be effectively achieved by manipulating the Bank Rate and co-operation between the Central Banks, so

long as the marketing of staple commodities, which enter into the general Index Number of prices, are [*sic*] carried on under competitive conditions," so he proceeds to a plan to apply stabilization to "certain basic raw materials and foodstuffs such as coal, petroleum, wheat, sugar, cotton, rubber, nitrates, and other similar commodities in universal and fairly constant demand."

Well, all this may happen some day and may be very nice when we have got it, though on the other hand regulation of the prices of staple commodities by international control opens a wide door to possibilities of economic mistakes. Mr. Lloyd, in his very fair examination of the objections to his scheme, admits that "a new use for rubber to replace some more expensive commodity, or the substitution of wheat for rice as the staple article of diet for the Far East, might enormously increase the demand for rubber and wheat and necessitate the raising of prices as the only means of checking consumption."

In the meantime, after this rather dizzy walk along the mountain tops in the company of minds that are able to soar into the region of the problematically attainable, let us get back to a less rarefied atmosphere and consider what in this world of workaday fact we should like to

see our monetary authorities doing or trying to do.

Should we "devaluate" the pound sterling to something like its present gold value and so hasten the return to a gold standard? Or should we continue the effort that we have begun to restore sterling to its old gold value and its old parity of exchange with the dollar? Or should we abandon all connexion between gold and our currency, and go frankly to paper officially regulated as suggested by Professor Soddy?

I think most of us will rule out Government control in view of all the crimes and follies committed by Governments during and since the war in their handling and abuse of our machinery of credit, that had been brought so near to perfection by bankers working for industry and commerce. It is rather amazing, seeing that we live in the midst of a world brought very near to utter shipwreck by the failure of Governments to do their international job decently, to find that any one should propose to put new duties, of the highest importance to our welfare, into the hands of our political rulers.

In one of Lord Macaulay's speeches on the Reform Bill, lately quoted by the *Times Literary Supplement*, he asked whether there

can be "any stronger contrast than that which exists between the beauty, the completeness, the speed and the precision with which every process is performed in our factories, and the awkwardness, the rudeness, the slowness, the uncertainty of the apparatus by which offences are punished and rights vindicated. . . . Surely we see the barbarism of the thirteenth century and the highest civilization of the nineteenth century side by side, and we see that the barbarism belongs to the Government, and the civilization to the people." Since Macaulay spoke there have been improvements, which he would have thought incredible, in our industrial processes, but at least in matters of finance the barbarism of Governments is even more barbarous than it was, as has been shown above, and the late war was not nearly as well paid for as the Crimean or the Napoleonic.

If ever the day comes when democracy or any other "cracy" can solve the problem of getting a continuous supply of the right people to do the governing job, and when all the other nations have done likewise, and when the nations have also learnt to live together so friendly and trustfully as to have confidence in an international paper currency, then perhaps we may be able to enjoy the use of a

paper currency regulated to keep prices steady. Until that far-off day arrives, we shall most of us agree that the gold standard, with all its faults, carried an immeasurable advantage in that under it the action of the Government was confined to the purely mechanical business of coinage. It also provided a machinery for international payments under which trade between nations was carried on with an ease and confidence which seem now almost incredible.

If then we want the gold standard restored, do we want the old pre-war gold standard, or a new one to be arrived at by a process of "devaluation?" The devaluation plan has high theoretical authority behind it, but as far as England is concerned our bankers have pronounced strongly in favour of the old pre-war standard, and even in countries like France and Italy the necessity for devaluation has not yet been admitted by those who guide their financial destinies. As to England even Professor Cassel now seems to think that it might be as well for us to restore the old standard.

The question was discussed with admirable clearness by Sir Charles Addis, Chairman of the London Committee of the Hong Kong and Shanghai Banking Corporation and a

Director of the Bank of England, in his Inaugural Address as President of the Institute of Bankers delivered in November 1921. He pointed out that if we accept the findings of the Cunliffe Committee that there are sound reasons for a return to the pre-war parity, then we must recognize that further deflation (using the word in the sense of a fall in prices) might be necessary, and he proceeded to put the case against deflation and in favour of devaluation as follows:—

"Why then, it may be asked, should we continue to wrestle with the burthen of deflation with all its attendant ills, when a way of escape presents itself, not by abandoning the gold standard, but by the simple expedient of altering it? Is there anything sacrosanct, it may be asked, in the ratio of 123 grains of gold or 4·86 American dollars to the pound? How could we be prejudiced if the pound were reduced to 92½ grains of gold and the American exchange to a new parity of 3·65 to the pound? It is true that gold would then command a premium of 33 per cent.; that is, it would be quoted at £5 3s. 8d. instead of £3 17s. 9d. per ounce in paper money, while the paper pound would be worth only 15s. in gold. What would that matter? It is worth a good deal less now. And as for the American

exchange, we should go back at a stroke to the much vaunted automatic standard system by which we set such store. Prices would be stabilized at the new level by gold flowing out when exchange fell below the new parity of 3·65, and flowing in when it rose above it just as it did when the parity was 4·86. Why not? "

And having thus set out the case for devaluation, Sir Charles then tore it to pieces. "An unlettered man," he said, "I never listen to the learned Dons—I hope I have stated their case fairly—who advocate this course, and suffer the charm and vivacity of their exposition, and realize my incompetence to make an adequate response, without feeling constrained to adjure them in the words of Oliver Cromwell to the General Assembly of the Kirk of Scotland, 'I beseech you, consider it possible you may be mistaken.' Do not let me be misunderstood. I intend no sneer. I hope I should be the last man to underrate the value of the theoretical economist. I am too sensible of my obligations. Where long periods have to be considered the theoretical economist is indispensable to business men. Indeed, if ever I felt tempted to treat his judgment lightly it would be sufficient, in order to render me dumb, to remind me of the great boom of 1920, and where our hand-

to-mouth business opportunism led us then. . . . But I must be allowed to remark with respect that it is not enough for a principle to be shown to be logically indefeasible in the seclusion of the economist's study. We have to take the world as it is. The principle must be brought down into the hurly-burly of the market place and proved in operation there, through the medium of the heart and mind of ordinary men, in conflict with their opposing interests, their changing purposes, their unruly passions and their defective wills. That, to my mind, is where Professor Cassel's devaluation proposal falls short. It may have all the merits claimed for it, but if it fails to take sufficient account of human nature, or, shall I say, of human nature as we know it in these Islands, it is doomed to nullity. To suppose that a people so conservative by instinct, so tenacious of custom, so careful of tradition, could be induced to trample on their monetary past and to relinquish the dearly purchased gold standard, which rightly or wrongly they believe to be bound up with the prestige of their national credit and their supremacy in international finance, is to live in a world of illusion."

Apart from these questions of conservative sentiment, on the great importance of which

Sir Charles laid such eloquent stress, there is also that of the claim of common honesty. It may be rather far fetched, but I think it is very real and relevant. We have been in the past a great place of deposit for other peoples both officially and individually, because London was thought to be a place where money could most safely be put with the certainty of getting it back. This was partly because of the freedom with which gold could be taken away and partly owing to our comparatively stable politics and our long freedom from invasion. Foreigners left and kept money here because they knew that when they wanted it they could take it back in gold. Thanks to the tricks that our Governments have played with our money any foreigner who had put money here before the war and took it away after would get a quantity of gold that would be less than he originally expected according to the premium on gold current on the day when he drew it. Unless he got a licence he could not take gold at all, and would probably take dollars and get so much fewer of them. It is easy to argue that this wrong has already been perpetrated, but I do not see that this justifies us in making it perpetual. It is surely worth while to make an effort so that we may show that although the war and the bungling and cowardice of our

rulers depreciated our currency, we put it back on its old gold basis as soon as we reasonably could. For the fact that gold has lost much of its pre-war buying power we can hardly be held responsible.

It is very true that if we attempt, in order to bring our currency up to its old gold value, to bring prices down by violent credit contraction and so take the heart out of our producers and traders, we shall be damaging ourselves more than could be expected by our reasonable creditors. In all these economic matters it is surely best to go very slowly. If we can induce our Governments to spend less than they get in revenue, and leave a balance for debt redemption, then at least we can be sure that there will be no new inflation on the war-time lines through faulty Government finance. Then as the volume of production and trade gradually grows it should slowly overtake the volume of money, restoring the value of the latter. Professor Cassel in his two Memoranda published under the title *The World's Monetary Problems*, expresses the opinion that is it a "particularly vain expectation" to suppose that the "general economic development will increase the genuine need for money so much as to match the present supply." He thinks that such a policy would

involve a continual depression of the general level of prices by about 3 per cent. per annum, and that "the most probable result would be a more or less complete killing of industrial enterprise, and of the very spirit of economic progress." On this point—the connexion between falling prices and depression, the Professor is strongly supported by Mr. Hawtrey, who says in his *Monetary Reconstruction* (page 145): "The relation of business depression to falling prices is so well recognized, not merely among economists but among practical men, that it is hardly necessary to labour the point. Experience has confirmed theory scores of times."

Shall we venture with Sir Charles to quote Cromwell to these learned pundits and beseech them to consider it possible they may be mistaken? We indeed dare to do so, because we have excellent authority on the other side. Mr. Hawtrey refers to the period 1873-96 as having been marked by a "chronic state of depression." Mr. W. T. Layton, now Editor of the *Economist*, on page 101 of his *Introduction to the Study of Prices* published in 1912, says that "the arts of production and the means of transport probably progressed faster between 1874 and 1896 than they had ever done before." He finds that national productivity depends much more upon the advance of

science and discovery and on the training, education and organization of labour than on the rise and fall of prices—"the Bessemer process of steel production was invented when prices were rising fast—the Siemens Martin process when they were depressed." He decides that "there is no reason to desire an advance in prices on the ground that it stimulates production" and that "on the whole the social well-being is best advanced when prices are stationary or slightly declining," and in a note he thanks Dr. Marshall for a "pregnant suggestion" that under an ideal currency system prices should fall at such a rate that receivers of fixed salaries should secure a fair proportion of man's increasing control over his material environment.

For a theoretical authority Dr. Marshall should satisfy the most exacting. He is also quoted by Professor Lehfeldt, in *Restoration of the World's Currencies* (page 123), as stating before a Royal Commission at a time when the continuous fall in prices provoked widespread complaint that "it wants very much stronger statistical evidence than one yet has to prove that the fall in prices diminishes perceptibly, or in the long run, the total productivity of industry." He maintained that a depression of prices, interest and profits was consistent with prosperity—"the employer

gets less, and the employee gets more"—not a bad thing when the uneven distribution of wealth is a cause of much social mischief.

Professor Lehfeldt himself adds that "whilst rising prices bring more profit to the employing classes, this very fact makes them careless, and the opposite conditions, which make it difficult to run business with profit, eliminate the careless and incompetent employers and screw the whole body up to a higher pitch of efficiency and enterprise"; and finally Dr. Snow in the *Manchester Guardian Commercial* article already quoted on page 245, says that in the leather producing industry "it is almost axiomatic that trade is good when prices are low and bad when prices are high."

It is true that falling prices would increase the weight of the debt charge. But it is safe to rely on high prices for securities if prices of goods are low, and so the course of the market would enable the debt charge to be lowered—perhaps cut in half—by conversion. In 1896 when the Index Numbers were at their nadir Consols touched their zenith—114.

We come then to the conclusion that the practical thing to do is to leave Index Numbers, stabilization, international conventions and Consortiums of Banks of Issue in the hands of the learned and able gentlemen who understand these matters, wishing them, with the

heartiest respect, all success in the task of working out a scheme of currency reform which will avoid Government control and will be accepted by all of them; and in the meantime to follow the line marked out by our leading bankers at the International Chamber of Commerce Conference held in 1921. Sir Felix Schuster expressed their determination to "return as soon as possible to the pre-war gold standard . . . whether it be this year, next year, or in five, six or ten years." The best way to get there is not to cut down our money but to increase our goods so that we may have cheapness through plenty and make England the best country to buy in. When we have got back the gold standard we can go on to think about Professor Lehfeldt's suggestion for a working agreement between United States and ourselves to stabilize gold prices by regulating the output of gold. In view of the close relations already existing between the Bank of England and the American Federal Reserve Board this proposal seems to be much more feasible than a European Consortium with a gold pool and a common Bank Rate. But even it—so close is the connexion between monetary policy and political money—could not be considered if a Presidential Election were anywhere within sight.

CHAPTER IX

POSTSCRIPT

FINISHED and delivered by the end of August 1923, the foregoing chapters, for very good reasons over which the writer had no control, went into cold storage for four months. Usually, cold storage has an even worse effect on the freshness of financial script than on that of chilled beef. But in this case the delay in publication brought with it several advantages. It enables me to record certain interesting developments in the stabilization theory and to show that, at least in one instance, the plea for stabilization looks very like our old friend inflation in disguise; and to refer, though briefly and after necessarily inadequate study, to Mr. Keynes's *Tract on Monetary Reform* published by Messrs. Macmillan early in December. And above all, the intervening period has provided a most timely and striking example of the effect on the minds of men, both at home and abroad and perhaps more especially

abroad, of a mere mistaken suspicion which made them believe that in order to cure unemployment, this country was going to adopt a policy of inflation.

This misapprehension was caused by some observations made by Sir Montague Barlow, Minister of Labour, in a speech at Nottingham on October 9. As reported by the *Daily Telegraph* of the following day he said: "I see it was announced in one of the papers yesterday that I was going to inaugurate and press on an immense scheme of inflation of one hundred millions sterling, and so on. Such a scheme has been put forward by no less an authority than the Chairman of Barclay's Bank, bearing the honoured name of Goodenough, and such a scheme is worth consideration, but I cannot myself plead guilty to being its author. All I can pledge you is this—that we are at work," etc. etc. It should at once be noted on the authority of Barclay's Bank's monthly review for November, that "Mr. Goodenough had not at any time made any such suggestion. Mr. Goodenough has been a persistent and steady opponent of inflation since the Armistice."

Commenting on October 17 on the sharp and sudden fall in the dollar value of the pound sterling that had followed the publication of

Sir Montague's remarks, the City Editor of the *Times* observed that "although the occasion of the speech was not an important one, its substance was telegraphed immediately *to all the chief* foreign centres, and a 'flight from the pound' on a small scale began immediately." And the *Economist* of October 20 pointed out that "through the indiscretions of a Minister, the foreign exchange market has been able to give a very useful lesson this week of the effects of a deliberate policy of inflation. To those, among whom the Minister in question appears to be included, unaware of the sensitiveness of this market and of the basis of confidence upon which the predominance of London as a monetary centre rests, the immediate removal of funds in some cases, and the thousands of anxious inquiries from every part of the world, showed very clearly what might be expected from such a policy."

Such was the effect of a hint by a Minister, who had not hitherto been an outstanding figure in British politics, that the Cabinet proposed to drop the policy of working back to the gold standard, and to dose unemployment with inflation. In a letter to the *Times* dated October 16 Sir Montague repeated a statement that he had made on that day to the

effect that he had been misunderstood and that no such change was contemplated; and in his speech at Plymouth on October 25 the Prime Minister dealt, in his hearty and outspoken manner, with the inflation scare. "You will," he said, as reported in next day's *Times*, "have seen, as I have, suggestions for creating out of nothing artificial money to finance this, that, and the other. It is not in that way that the problem of unemployment is to be tackled. There is no truth whatever in any stories that you may hear from any quarter that any Government of which I am a member will depart from what is understood in this country to be sound financial policy. It is well that this should be understood clearly at home and abroad, as great harm is being done to British credit, on which so much depends, by loose talk about inflation. People are about as accurate when they talk about inflation and deflation as they are in the use of inverted commas. We are not in present circumstances, any more than we have been for many months, pursuing a policy of active deflation, and we certainly do not propose to proceed in the direction of inflation. No such project has ever been considered."

Mr. Baldwin ended his remarks on the subject by saying he hoped this would "lay

the ghost," and he had certainly done his best for that purpose. But then came the General Election with the Labour Party putting a levy on capital into a prominent place in its programme, and so the sensitive nerves of foreign holders of sterling had another uncomfortable shock. It may be very tiresome that British financial prestige should be thus affected by mistaken apprehensions, but the fact being so, it is evidently necessary for prominent people who discuss our monetary policy to do so with most careful caution and in terms that cannot be misunderstood, unless they believe that financial prestige is an overrated asset that is less important than the objects that they hope to secure.

As it was there has been a good deal of loose talking, quite enough to make the apprehensive foreigner believe that though Mr. Baldwin has effectively laid the inflation ghost as far as he and his Government can control its appearances, there is nevertheless an important body of opinion in this country which would welcome its return, re-embodied in a live and full-blooded doctrine. On October 20, Mr. St. Loe Strachey published in the *Spectator*, which under his editorship has maintained its great name as a thoughtful and independent leader of English educated opinion, an article

saying: "We hold with financial experts like Mr. McKenna, Mr. Keynes, and others, that a great deal of the present unemployment, possibly the whole of it, is directly due to the policy of deflation," and arguing that "as long as there is unemployment the Government may safely and without thinking about foreign buyers, help trade by not frittering their money away, as Sheridan put it, by paying their debts." Mr. Strachey also submitted the article before it was published to Mr. McKenna, and so was able to print before it a letter from him in which Mr. McKenna endorsed Mr. Strachey's analysis of the financial position and added: "I am glad that you do not minimize the evils of inflation, but there can be no question that deflation is not less injurious. A policy either of inflation or deflation should never be adopted, as you say, except as a corrective, and the degree of unemployment at any given time will always furnish a test of the right medicine to be applied."

In spite of Mr. McKenna's emphatic reference to the evils of inflation, the words last quoted from him can be easily read to mean that it is nevertheless a cure for unemployment, to be applied freely when the evil is rampant. In fact, if they do not mean this, it is hard to see what they do mean.

In an address that he delivered before the Belfast Chamber of Commerce on October 24, Mr. McKenna chose his words more carefully. He argued strongly against deflation, but disclaimed any desire for inflation. "When," he said, "unemployment is greatly in excess of the normal we should abandon unhesitatingly the deflationary policy which is a cause of unemployment. But let me not be misunderstood. I do not say that a change in official policy would have the same far-reaching effect in this country as in America. Neither do I say that we should pursue a policy of monetary inflation. . . . The evils of such inflation are present to all our minds. . . . Personally I have no fear of a recurrence of monetary inflation. The high traditions of the Bank of England were never in safer keeping than in the hands of the present Governor, Mr. Norman. Neither the Prime Minister, now the Chancellor of the Exchequer, nor the Governor of the Bank of England is likely to countenance such a policy."

In a previous passage in the same address, Mr. McKenna had contended that in this country "deflation was actively continued until three months ago and still nominally stands as our official policy. . . . Our bank deposits to-day show a decline of 10 per cent. This

means a severe restriction of purchasing power and a consequent lowering of prices, which is indeed the declared purpose of a deflationary policy. . . . Very little argument is needed to show that a policy of driving or keeping down prices by a restriction of purchasing power must depress trade. . . . If the merchant or manufacturer thinks that prices are going to fall, he will restrict his orders for finished goods or raw materials. . . . What is the consequence? Men and women are thrown out of employment, less is paid in wages and the amount spent upon consumption is reduced." Mr. McKenna's authority on these matters is worthy of all the respect that it so widely commands, but I still venture to submit that there is strong ground, as shown in Chapter V above, for the view that deflation did not cause depression, but followed it and was caused by it. The collapse in trade began abroad, long before there had been in England any reduction in purchasing power as measured by the volume of bank deposits. Bank deposits shrank because trade was inactive and prices were lower and credit was not wanted. The deflation of which he complains, as having been actively continued until three months ago, was the system against which he argued so vigorously in his speech to the Midland bank shareholders

at the end of January 1923, by which the Government sold Treasury bonds to investors and with the proceeds bought Treasury bills held by the banks, thus reducing the banks' investments or discounts, and likewise their deposits. But if trade had been active and the demand for credit keen, this process need not have produced deflation; because the banks might have replaced the Treasury bills paid off by discounting commercial bills or increasing their advances to customers, and so the level of their deposits would have been maintained, the purchasing power in the hands of the public would have been restored and the banks would have been doing their proper business of financing trade instead of providing credit for the Treasury.

In this country, which lives so largely on its foreign trade, trade depression and unemployment are usually produced by external matters which are little influenced by our monetary policy. This is especially so at present. In the same address Mr. McKenna told his Belfast audience that "when we turn to trade we have to deal with conditions, many of which are not under your control. . . . Your prosperity rises and falls with the prosperity of Great Britain and of the world generally, and an impoverished and disorganized Europe can-

not fail to react upon Belfast and be reflected in unemployment and diminished profits. . . . You, like Great Britain, are dependent in an exceptional degree upon foreign trade. . . . If we are to recover the level of activity attained before 1914, we must first of all re-establish throughout Europe the conditions of peace and stability which then existed."

These weighty words are, as need hardly be said, as true of England as of Belfast. And they surely go a very long way to disprove the contention that "a great deal of the present unemployment, possibly the whole of it, is directly due to the policy of deflation."

Sir Eric Geddes, who has earned all our gratitude by lopping with his historic axe the extravagance of our official wasters, and now speaks with added authority as President of the Federation of British Industries, was the next "star turn" in this performance. Speaking at a meeting of the Scottish members of the Federation at Glasgow on October 23, he doubted whether we could support, in addition to all the other difficulties, "the effort and sacrifice involved in a continuous appreciation of our currency." (In fact, the value of our currency as measured by the *Economist* Index Number has shown very moderate fluctuations since December 1921.) "We had," he said,

"now been deflating our currency very heavily for a number of years. . . . There should surely be some connection between the financial policy of the country and its trade situation. The bad trade of the world was not of our making; inflation in foreign countries we could not control, but our own financial policy we could control. . . . A large number of people were jumping to the conclusion that those who proposed a reconsideration of monetary policy desired to suggest 'inflation.' He rather suspected that most of those who jumped to this conclusion had very little notion of what inflation meant, and he would suggest that they might wait until the Federation had said what it did mean, instead of accusing it wildly of all sorts of things which had never entered its head." (*Times*, October 24, 1923.)

Next day the Federation said what it did mean in a report addressed to the Government on the subject of unemployment and published in the papers of October 25. It expressed, among many other interesting observations on our economic difficulties, its belief that "the interests of trade and of the country as a whole will be best served by a stable monetary policy which aimed at keeping the price level steady." But this sweet draught of the pure milk of stabilization was spiced, as so often happens,

by the addition of a highly important ingredient. "At the moment," the report continued, "we are at the depth of an extremely serious depression of trade. Past experience shows that in such conditions a certain upward movement in prices is an invariable and inevitable accompaniment of the process of recovery. The object of a policy of price stabilization, therefore, should not be to stabilize prices at the abnormally low level shown by the index numbers at the bottom of a severe depression, but at such an increase on this level as normal trade activity would entail."

"But," inquired the *Economist*, in commenting on this report, "are prices abnormally low, and, if so, on what standard?" What the Federation seemed to mean was a rise in prices brought about by monetary manipulation. But is not this something very like the inflation which according to its President had "never entered its head"? And who is to decide how much rise in prices normal trade activity would entail? And if the rise were brought about and cheered people up, would not there be an overwhelming clamour in favour of its continuance by the same method?

And now comes Mr. J. M. Keynes, clad in the shining armour of his outstanding ability and fame, and tells us in his *Tract on Monetary*

Reform that "the gold standard is already a barbarous relic" and that "the Cunliffe Report belongs to an extinct and an almost forgotten order of ideas." He puts the case for the gold standard into one limpid sentence. "The advocates of gold, as against a more scientific standard, base their cause on the double contention, that in practice gold has provided and will provide a reasonably stable standard of value, and that in practice, since governing authorities lack wisdom as often as not, a managed currency will, sooner or later, come to grief." He admits the remarkable success with which "gold maintained its stability of value in the changing world of the nineteenth century," but he thinks that "we have no sufficient ground for expecting the continuance of the special conditions which preserved a sort of balance before the war." He shows that during the nineteenth century progress in the discovery of gold mines roughly kept pace with progress in other directions, but in his opinion, "this stage of history is now almost at an end. A quarter of a century has passed by since the discovery of an important deposit." If this be so, those who are seeking capital for the development of what is alleged to be a wonderful new field in Canada have lively imaginations. Moreover, if it be so, the disposal of

the enormous mass of surplus gold now held by the United States, which seems to Mr. Keynes to be so great a menace to us if we return to the gold standard, becomes a much less formidable problem. If it be true that no new great discoveries can be looked for, its gradual scattering over the countries of the world, as they return to peace, sanity and sound currencies, should not be a matter of overwhelming difficulty.

With regard to the other argument in favour of a return to the gold standard—that it frees us from the fear of ill-considered interference by Parliament with our monetary arrangements—Mr. Keynes's argument seems to be still less convincing. He says most truly that "experience has shown that in emergencies Ministers of Finance cannot be strapped down": but surely that is a bad reason for turning them loose to do their worst at all times. And he adds that "there is no escape from a 'managed' currency whether we wish it or not: convertibility into gold will not alter the fact that the value of gold itself depends on the policy of the Central Banks." But it may be suggested that the policy of the Bank of England, working on traditional lines which the whole business world understood, is a different matter from a

policy which is to be complicated by the deliberate intervention of the Treasury, which would be dangerously open to pressure from interested parties in Parliament.

When he comes to positive suggestions for the future regulation of money, Mr. Keynes says that hitherto the Treasury and the Bank of England have "looked forward to the stability of the dollar exchange (preferably to the pre-war parity) as their objective." His scheme "would require that they should adopt the stability of sterling prices as their *primary* objective." If they did so, Mr. Keynes doubts the "wisdom and practicability" of so cut and dried a system as Professor Fisher's, which is to work merely by reference to an index number, without any play of judgment or discretion. "If," he says, "we wait until a price movement is actually afoot before applying remedial measures, we may be too late. . . . Actual price movements must of course provide the most important datum; but the state of employment, the volume of production, the effective demand for credit as felt by the banks, the rate of interest on investments of various types, the volume of new issues, the flow of cash into circulation, the statistics of foreign trade and the level of the exchanges must all be taken into account. The main

point is that the *objective* of the authorities, pursued with such means as are at their command, should be the stability of prices."

I think it is probable that most of these considerations were not altogether overlooked by the Bank Court in old days under the gold standard, when it was deciding whether it was necessary to move its official rate. Its object was to preserve its gold reserve with a view to the convertibility of its notes. By this method it maintained our prices roughly on a level with those in other countries and so secured stability both in prices and in rates of exchange. This is surely better than (possibly) stabilized prices, with unlimited fluctuations in exchange.

As to the means to be used to secure the contraction and expansion of credit needed to preserve stability, Mr. Keynes looks to joint control, exercised by the Treasury and the Bank of England. He says that the extent to which the Treasury draws money from the public to discharge floating debt depends on the rate of interest and the type of loan that it is prepared to offer; and that "the Bank of England is also, within sufficiently wide limits, mistress of the situation if she acts in conjunction with the Treasury. She can increase or decrease at will her investments and her gold by buying

or selling the one or the other. In the case of advances and of bills, whilst their volume is not so immediately or directly controllable, here also adequate control can be obtained by varying the price charged, that is to say the bank rate." The Bank's buying and selling prices for gold would be announced every Thursday morning at the same time as its discount rate; and gold would be retained as a reserve against emergencies and "as a means of rapidly correcting the influence of a temporarily adverse balance of payments." How it would do so, if America and other countries also adopted Mr. Keynes's policy, is not clear. For they might put down their buying prices to a prohibitive level or refuse to buy gold altogether. One does not see why they should take it at all; for Mr. Keynes proposes that the gold reserve should be separated entirely from the note issue, the volume of which would depend on "the state of trade and employment, bank rate policy and Treasury bill policy." If everybody worked on these lines who but dentists and goldsmiths would want gold?

It is a most interesting and ingenious scheme, but I venture to think that it does not answer two objections, put forward in my previous chapters, to proposals to regulate prices by means of credit and currency management.

(1) Though it is possible to contract credit by raising its price, if those responsible are prepared to risk panic, it is not always possible to expand it by lowering the price or even by the Bank of England's making purchases of securities, unless producers and traders can see their way to using it profitably, and in a country like England, so subject to foreign influences on her trade outlook, depression might easily arise that could not be cured by domestic monetary devices And even when credit is expanded prices do not always rise, as was seen in the years 1890 to 1895

(2) The intervention of the Treasury involved by Mr Keynes's proposals, opens a door to interference by the House of Commons in a sphere in which its activities are far from desirable

The gold standard frees us from muddling with our money by politicians, has worked right well in the past and may do so again, whenever the politicians succeed in doing their proper job, of giving us peace and security and confidence and good will